

Foreword from
Stuart McLauchlan
Chairman,
Institute of Directors in NZ



GOVERNANCE IN ACTION GLOBALLY

Strategy, Process and Reality

Jens Mueller • Philippa Wells

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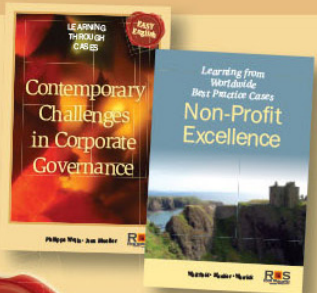
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Jens Mueller
Philippa Wells



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Strategy and the Board: A Division of Labour

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**The Story of a Tortoise:
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Neither Arthur nor Martha: Reflecting on Governance Issues for State Owned Enterprises through the Lens of Solid Energy, New Zealand

Philippa Wells

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When NGOs Invest the Field of Public action: Evidence from a Sub-Saharan African Country

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Konan Anderson SENY KAN

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Mi Casa es su Casa?**Leadership Challenges in non-Profit Governance***Adrian Velazquez*

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**Governance in a Non-Profit Organization,
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Institute (SERI)***Jana Price-Sharps, Amy Tillery, Elizabeth Poulsen,
Lisa Giuliani, Stephanie Vucovich-Cholakian,
Jennifer Roy-Pogutter, Elaine Newborg, Ben Adam,
Schuyler Liao & Rizza Bermio-Gonzalez*

How the particular governance structures of a particular NPO (SERI) allows it to be particularly sensitive and responsive to community needs, allowing SERI to excel at organizational emergence and responsiveness to community change.

FOREWORD

Without doubt, corporate governance is one of the most significant contributors to stellar corporate success – and to abysmal failures. Especially for our many small- and medium-size entities, corporate governance is often considered an unnecessary luxury, to be reserved for times when the firm has grown substantially. This is as helpful as the idea to take the old family sedan onto the Indianapolis race track and use the winnings to buy a race car. There will never be any winnings; the family car will be destroyed and the race is lost! Governance is an integral part of the planning prior to starting a business; it helps guide the business through the ever-present turbulence; and it is essential when the business is ready to sell itself, merge, or close.

It is books like these that provide a practical insight into the way sound governance systems can be set up. Good governance is no mystery. It requires a solid focus on the desired outcomes of an organisation; accountability through all levels; close connection with the external stakeholders and total transparency. Entities with a good structure for governance are well-understood firms where everyone knows what needs to be done, and how to avoid doing it incorrectly. Governance reflects the direction set by the leaders and their expectations. Whether in a large business, a government department, a church or a small bakery; we cannot expect superb performance unless we clearly define the goals and aspirations. It is refreshing to see these many chapters focus on how board directors set goals, establish clear accountabilities and then hold everyone to the stated objectives.

Leaders do not shy away from complex and expensive decisions. With good transparency and trust within the organisation, management and staff are invited to submit information so that directors can make informed decisions. Involving management in that process is essential to make sure that directions are understood and followed without ambiguity.

FOREWORD

The chapter on how board directors contribute to the shaping of long-range corporate strategy is a solid foundation to understand that leaders must focus on the future to chart a course for a firm that creates a sustainable success. Governance, when poorly executed, produces failures.

The case of Toyota losing its Number 1 spot in the industry shows what happens when boards look more into the rear-view mirror than into the future, and then react too slowly to recover from the inevitable missteps organisations experience. If you fail, fail quickly and then have a solid remedial plan ready to create learnings from failures and move towards success.

With the many SMEs contributing the lion's share of GDP in most countries, the focus on Governance during financing decisions is very helpful. We know a large reason for failure in SMEs is undercapitalisation, an issue that connects directly with the competence of an organisation's leaders. Decisions to operate without a solid financial basis is not just reckless and legally risky, it can destroy enormous social capital and the expectations of staff and stakeholders for a successful business.

I have never been much for reading long text books, and this approach of blending many short chapters into an interesting quilt of corporate governance is a fascinating approach – well worth a read!

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BIOGRAPHY *Philippa Wells*



Philippa Wells is an Associate Professor in Law and the University of Ballarat, Australia. A New Zealander by birth, nationality and inclination, she has published a range of areas including commercial and company law, governance, environmental history and policies around sustainability and during her long academic career has taught and supervised a broad range of undergraduate and graduate students in a variety of legal areas of importance to business. She has legal and management qualifications while her PhD study focused on New Zealand environmental history. This is the second book on governance that Dr Wells has edited.

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Chapter 1 INTRODUCTION

Contents and Background to Governance

The history of thought around corporate governance has always been affected by the historically relevant context in which that thought evolved. An important insight emerged in 1932, when Berle and Means argued that a separation between a firm's owners or investors and a firm's managers has significant positive implications for industrial capitalism. As firms increased in size with the advent of modern communication and manufacturing technologies, operating costs fell. As a result, many firms increased in size and scale (Coase, 1937). Further technological advances allowed for machine-based mass production, and firms' outputs increased, causing the size, scope and scale of firms to grow even more (Clark, 2009). To address these increases in size, scope and scale, managerial organizations tended to employ a vertical integration business strategy. As a result businesses became driven less by market forces and more by administrative structures and managerial coordination (Clark, 2009). Increasingly, managers were allotted more decision making power and business owners and equity holders trusted managers to act in their best interests.

However by the late 1950s, business theorists began to notice a divergence in the behaviour of managers and the expectations of business owners and equity holders as to how those managers should behave. Galbraith (1952; 1967) described that the aforementioned developments led to businesses competing for market share instead of profit maximisation. This was a direct result, he claimed, of managers being allowed more discretionary decision making. Baumol (1959) stated that managers measured business success in terms of growth in market share, whereas owners measured success through sales revenue and profit maximisation. Accordingly, Marris (1964) and Williamson (1964) argued that long-term growth of a firm was the management's priority, as opposed to profit maximisation. Managerial priorities could also include reputational success, job security, industry profile and other perks (Jensen and Meckling, 1976). (It is noted that absent from such priorities it is the now-prominent focus on sustainable

operations that would bestow benefits on both operators and owners of firms and likely establish a more long-term valuation of a firm's success.)

However, and despite the above, until relatively recently, research and theorisation of corporate governance tended to be confined to the academic sphere: 'a relatively obscure concept with narrow legalistic connotations' (Seal, 2006, p. 389), or an arcane and economic theory-driven line of research that was, for most practical purposes, largely irrelevant. How times change: Seal (2006) cites Gordon (2002) in support of his point that it was not until the revelations during the Enron meltdown of widespread problems and criminal and negligent behaviour that serious doubts were raised over the value of the 'myths' (Seal, 2006, p. 390) of governance that were routinely taught at Universities: ...auditor independence... "Chinese walls"...and "efficient" capital markets' (Seal, 2006, p. 390).

This growing popular interest in the last decade (Tosi, 2008) has been fed by the many recent bankruptcies and liquidations that have also highlighted the fact that there is no explicit contract to protect the interest of owners. Instead the interests of owners lie largely in the hands of managers (Heath, 2009). The well-publicised downturns of purportedly stellar organizations worldwide, from Enron and WorldCom in the USA, Siemens in Germany, Satyam in India, San Lu in China through to South Canterbury Finance Corporation, Feltex Carpets in New Zealand has fed this growing interest. On one hand, it is arguable that this intensified discussion of governance in the populist media has blurred consideration of the theoretical underpinnings, and pilloried directors as parties responsible for every corporate failure. However, on the other, it is also arguable that it has also driven directors (and their equivalents in organizations other than companies) to pay closer attention to the issues around governance, not only to protect their own position but also to address the broader concerns, purpose and focus of the organization.

To inform opinions or views on governance or its failure, or means of designing, maintaining or improving the processes that contribute to governance, it is useful to begin with a definition. A recent (and broad) definition is given by Colley, Stettinius, Doyle and Logan, (2005, p.5), 'Today, the public corporation itself operates as a form of representative government. The owners (shareholders)¹ elect directors as their representatives to manage the affairs of the business. The directors, who as a group are

1 It is worth noting that although the term "owners" is frequently used to describe shareholders, there is a persuasive argument to the effect that it is both misleading and legally wrong to use such a term. At best, shareholders have a residual claim to assets of a company after all debts are paid. Other rights normally associated with ownership – including full and unfettered rights to make decisions in respect to those assets (proprietary rights) – are just not there.

referred to as the board of directors, then delegate responsibility for actual operations to the Chief Executive Officer (CEO)/Managing Director (MD), whom they hire. The CEO is accountable to the board of directors, which, collectively and individually, is accountable to the shareholders. In addition to its role in selecting the CEO, the board also advises on and consents to the selection of business and strategies of the firm, as well as oversee results. In sum, this system of authoritative direction, or government, is known as corporate governance’.

More commonly and tersely, however, corporate governance is defined as ‘a set of relationships between a company’s management, its Board, its shareholders and other stakeholders...also providing the structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance are determined’ (OECD 2004, p.11). If an important aspect of this definition is ‘a set of relationships’ then one should ask how such relationships are supported, key objectives attained and performance monitored?

So in brief, governance is reflected in relationships that support a structure and processes that in turn enable and support the identification and achievement of organizational objectives. Some of these structures are commonly prescribed by law (such as shareholder rights in general meeting, accountability and reporting mechanisms for companies, reporting and financial accountability to certain stakeholders in the instance of non-profit organizations). This is not new but has developed over time as a means of addressing changes to the environment, the nature of organizations, their activities and size. Indicatively, in many developed countries and for many years, legislation around corporate conduct has stipulated direct and/or indirect compliance requirements for businesses. These have increased in number since the accounting scandals at the beginning of the millennium (Abdel – Kahlik, 2002; Benston and Hartgraves, 2002). Relevant legislative measures implemented by various jurisdictions have included adjustments to the auditing process, refinement of financial reporting standards, strengthened internal managerial controls, monitoring of compensation packages and development of online security and other technology standards (Bhimani, 2008). In 2002, Canada’s Ontario Securities Commission passed Bill 198 aimed at achieving ‘better corporate governance’ (Ferris, 2007, p. 31). Generally, the requirements of corporate governance legislation are aimed at encouraging ethical corporate behaviour.

However, governance is broader than assuring mere legal compliance, a breadth that is reflected in the way in which it has been defined and

the context-drive rationales offered for such definition. It is important to distinguish between corporate governance per se and good corporate governance. As can be seen from such examples as Enron, Ansett and Parmalat, the term ‘governance’ is value-free. All these companies did have governance mechanisms in place: they all proved unequal to the task of achieving long-term firm performance in their particular contexts. The question then is: what constitutes good governance? Some indication can be gleaned from the following discussion.

According to the OECD (2004) corporate governance has two principal purposes: to improve economic efficiency and growth (the macro effect) and to promote improve investor confidence at a company or firm level (the micro effect). In the preamble, the OECD explains the intention of the document: to assist OECD and non-OECD governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries, and 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’ (presumably ‘good’ being a value to be conferred where the relevant structures and institutions achieve the desirable outcomes of shareholder and stakeholder welfare). It is arguable that corporate governance is only good where the processes, expectations and rules maximise the benefits that emanate from the range of relationships between the corporation and other interests (the range of whom depending on the theoretical construct) (effectiveness). The benefits should be greater than the costs of delivery – only then is the corporate governance regime efficient.

In accordance with such conceptions, the protection of owners/shareholders interests is often woven into the definition of good corporate governance: ‘If we follow the traditional Anglo-American conception of the firm as a device to further the well-being of its owner-shareholders, good governance is a matter of ensuring that decisions are taken and implemented in pursuit of shareholder value’ (Keasey, Short and Wright, 2005, p. 2). Consequently, tension between boards and shareholders is often cited as evidence that the governance structure is not sufficiently assigned with shareholder interests or objectives (Shleifer and Vishney, 1997) and/or is not adequately robust. Good governance requires the creation and implementation of a model that is both robust and appropriate, an imperative not just for companies (which is the traditional context in which to consider governance) but for all types of organization.

Hence this publication that is intended to address some of the issues around how and why organizations adopt particular governance approaches and structures. The contributions from a range of international authors are thought-provoking, interesting and informative about issues around governance and its application. Given the range of topics, contexts and arguments, and in the interests of easy use and navigation, the book is divided into three parts. Each part contains an introductory chapter (specifically *chapters 2, 10 and 16*) that provide a theoretical overview and set the theme for that part. These introductory chapters also provide a brief introduction to the contents of the parts (that is, the other chapters included within them). It should be noted that where chapters could arguably be associated with more than one theme, the decision of “best fit” is solely that of the editors. Each chapter (apart from the introductory ones) contain teaching and review questions.

Part II (including *chapters 2-8*) focuses on the main theoretical constructs that have dominated the literature and design of governance systems and explores the challenges that arise from those theories, in a philosophical context and from the perspectives of relevance and effectiveness in given situations. Part III (*chapters 9-14*) is dedicated to one structure of governance, the Board or its equivalent, providing insights into how and what makes a board effective and suited to its purpose. Finally Part III (the largest of the three parts containing the balance of the *chapters – 15-28*), looks at governance in its cultural and/or organizational context, more particularly issues specific to emerging economies, non-profit and non-governmental organizations, state owned enterprises and small to medium businesses.

As a final note to this chapter, the editors would like to thank all those who participated in this work. They patiently put up with the expectations and requirements placed upon them by demanding editors and reviewers. We hope that they, like the readers and users of this book, find the outcome worthwhile.

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Chapter 2

Main Theories Impacting on Governance Design and Practice

Jens Mueller & Philippa Wells

The purpose of this chapter is to provide a discussion of the main theories that have been offered as frameworks within which to describe and evaluate governance systems, policies and frameworks. It is neither intended nor practical to cover all these in detail: rather the focus is on their rationale, principal consequences and grounds for criticism. As well as providing an overview, this chapter also usefully serves to contextualise the chapters that look in considerably more detail at some of the debates, consequences and impacts of particular ways of looking at governance, its focus and objectives.

The first theory to be considered is agency, a theory of both historical and continuing importance in this context. This theory (Jensen and Meckling, 1976; Eisenhardt, 1989; Kang and Sorensen, 1999; Lockhart, 2007), together with other contractually based theories such as transaction cost economics (Fiss 2008), has for many decades come to dominate Governance literature, particularly in relation to the Anglo-American model of corporations and their management structures (Bainbridge, 2008; Daily, Dalton and Canella 2003). It has been and, at times still is, of significant importance in grounding a normative structure not only for business corporations (Rossouw, 2009) but also for reform of public and even certain non-profit sectors (Wallis, 1997; Hazeldine and Quiggan, 2005; Bale and Dale, 1998; O'Neill, MacIntosh and Hall, 2006). Other theoretical frameworks to be considered are stakeholder, stewardship, institutional, resource dependency and finally, the relatively new Entity Maximisation and sustainability model (EMS).

Agency Theory

The term “agency” emerges from law, where it is used to refer to any situation where one person (the Principal) appoints or otherwise has another person (the Agent) acting on his or her behalf. The agent cannot

do more than the Principal as his or her legal capacity is bounded by that of the Principal. The Agent's capacity will usually be further restricted by the terms under which the Agent is authorised to act. This position involves a range of fiduciary duties, including the duty to place the interests of the principal before those of the agent, (b) to account or disclose to the Principal movements of those funds, (c) a duty to avoid conflict of interest, (d) a duty to use expertise for the benefit of the Principal, and (e) a duty to be diligent.

How is this theory relevant to corporate governance and what are its implications?

The relationship between manager and owner² in the company setting is a classic example of agency (Blair, 1995; Campbell, 1997; Eisenhardt, 1989; Jensen and Meckling, 1976; Milgrom & Roberts, 1992) with this relationship requiring control over the behaviour and decisions of the "agent" (CEO) (normally through the medium of the Board of Directors) (thereby advancing shareholder primacy). The theory is also arguably applicable to the relationship between the directors and the shareholders. On first glance this seems both logical and a good fit – after all, separation of ownership (or its equivalent) and control has and remains the standard shape of many organizations in the commercial private sphere and, in some cases and whenever relevant, the public and non-profit sectors.

The underlying justification for the application of this theory to governance (Berle and Means, 1932; Fama and Jensen, 1983; Spence and Zeckhauser, 1971) is that if managers have a significant level of control over a firm, and are unrestricted by market forces or internal governance mechanisms, they will tend to promote their own interests rather than those of the equity holders whenever the interests of the firm's equity holders and the managers diverge (Tosi, 2008). This conflict of interest may undermine the effectiveness of management for the enterprise. Eisenhardt (1989, p.61) also refers to "moral hazard" that comes from a situation where the agent (CEO) does not do what is expected of them – in other words, they shirk their responsibilities (also see Bainbridge, 2008; Core, Holthausen and Larker, 1999; Heath and Norman, 2004). Such strategies clearly increase the costs and risks borne by the company and contribute to a significant disconnect between the shareholders' and CEO's objectives. It may also ultimately have a negative effect on the market (as in the case of WorldCom).

² As shareholders have no direct claim over company assets and no direct liability for its debts, some argue that they cannot be defined as "owners" at all: merely residual claimants against the net worth of the company.

This is not new. From the creation of the first statutory framework for companies, there was evident concern as to how activities of management could be policed (Hermalin and Weisbach, 2003). Legislation then and now provides for the split between the powers of the Board of Directors and those of the shareholders in the General Meeting (SGM), seeks to ensure certain powers of the Directors cannot be performed without approval of the shareholders, and specifies shareholder access to important information.

Briefly, and very much a product of its economic parentage, agency theory requires certain assumptions to be made (albeit overlapping ones, Eisenhardt, 1989). One is rationality: All other things being equal, any person will make a decision that maximises his or her return on investments like time or money. The second such assumption is that everyone is motivated by self-interest (although it does not necessarily mean they make decisions with selfishness or guile; McCure and Prier, 2008, p. 47). Consequently (and again assuming all other things are equal with no economic distortions), a person will work to benefit him or herself the most. Thirdly, because interests of principal and agent diverge, there must be conflict between those interests and thus a process to resolve those frictions. Fourthly, a person who is overly focused on their own benefit will have an aversion to risk (at least where it would affect them adversely). Fifthly, the theory assumes that shareholders are imperfectly informed as to the work of management and must therefore rely on another to act on his or her behalf. A “univocal” (Letza, Kirkbride, Sun and Smallman, 2008, p. 23) interest for shareholder/owners is assumed, meaning that any individual differences are ignored. Finally, there is the question of how self-interest can be controlled and aligned with those of the organization, a question that is answered by processes of monitoring (both external (market and regulation being the two most important) and internal) and control.

Takeovers are the main external means through which to demonstrate to incumbent directors that the market believes the firm could do better in the hands of more competent leaders. For example, the results obtained by Franks and Mayer in two studies (1985 and 1986) suggest that unsuccessful hostile takeover bids produced management dismissals, and this was explicable from the point of view of the board either as a reaction to failure of previous bids or because of connections between management and the bidder or because of a realization that external parties value the company higher under their own management.

Capital markets are also identified as an efficient means of providing external monitoring of the CEO and Board. Stapeldon (1996) suggested that

a poorly run company would find it hard to raise finance on the market and therefore would have to pay a risk premium, thereby reducing the return to shareholders and causing them to bail out, or at least ask awkward questions. Arguably too, with the shift by investors from reliance on the expertise of insiders to the market as the indicator of corporate prosperity and performance (Gordon, 2007), i.e. the efficient market hypothesis or efficient market model (Blair, 1995, p. 107) these markets serve as objective observers, undistorted by human frailty or preference, with information available to all and costs evenly distributed.

The popularity of market-based mechanisms does not infer there have been no critics. Letza et al (2008) refers to the “competitive myopia” implicit in agency theory (Letza et al., 2008, p. 19) and its “preoccupation with short-term gains in return, profit, stock price and other performance measures” as discouraging managers (including the CEO) and the Board from concentrating on longer term strategic issues and competitiveness. This in turn forces them to act in a way that is inconsistent with the future wealth maximisation of shareholders – the very outcome agency theory is determined to achieve.

The other main form of external monitoring of management is via regulation, although critics (Guttentag, 2007; Laufer, 2006; Smallman, 2007; Tomasic, 2006) have questioned why and how. Starting with the Companies Clauses Consolidation Act (UK) 1845, rules relating to shareholder rights were introduced (in this case via the external audit (ss101-108) and the power of general meeting to elect directors (ss90-91). This has grown over time to include such requirements as periodic and continuing disclosure (reporting to SGM and to the Stock Exchange), disclosure of directors’ interests, expanded audit requirements and the burgeoning push for the presence of independent directors on the Board in an increasing range of jurisdictions (Sarbanes-Oxley Act 2002 -USA) and Listing Rules (NYSE 2010), and principles of corporate governance in the UK (Financial Reporting Council, 2010), Australia (Corporate Governance Council, 2010) and New Zealand (NZX, 2010).

Internal monitoring mechanisms are frequently financial based: most particularly compensation, the term used to refer to the total package of fixed and variable incentives for performance offered to management, specifically for our purposes, the CEO (Fama and Jensen, 1983; Jensen, 1994; Matsumura and Shin, 2005; Ramsay, 1993). Compensation, if not necessarily the most common of these mechanisms, is arguably that which has received the most media and research attention. It has

become the norm for CEOs and other managers to negotiate performance-based packages from their employing companies (Bebchuk, Fried and Walker, 2002).

The other form of monitoring can be described as non-financial - mechanisms and processes put in place by the shareholders/Board to scrutinise, control or map the decisions of the CEO/Board or the outcomes from them (Boards in a world of director primacy (Bainbridge, 2008); shareholders where shareholder primacy is the predominant model (Stapledon, 1996; Davies, 1993). Such a strategy will reduce the incentives that need to be provided to CEOs and other managers (reducing direct agency costs for the company) and at the same time reduce their freedom of action and autonomy (reducing their risk). However, it should be noted that this mechanism relies heavily on the availability to the monitoring body (normally the Board or possibly a block shareholder such as a pension or investment fund) of reliable and complete information. Eisenhardt (1989) makes this point clearly: the more complete the information, the more positive is the relationship to behaviour-based contracts. In addition, the Board needs to be strong in relation to the CEO (Borokhovich, Parrino and Trapani, 1996) and, perhaps more importantly, to be able to obtain and use the information in an efficient and effective way (Baysinger and Hoskisson, 1990; Jensen, 1994; Coles and Hesterley, 2000).

The above discussion focuses on the role of agency theory in conceptualising and formulating the actual and “metaphorical” (Eisenhardt, 1989, p.58) contracts between the CEO and the Board/shareholders as monitors and the external market environment as providing discipline. This focus was in response to a point made in the introduction - that agency theory “dominates” the field of corporate governance literature, particularly in relation to the Anglo-American model of the large corporation. However, as also mentioned earlier, agency theory as a normative reward and control structure is not limited to the public, commercial corporation but has underpinned fundamental restructuring in the public and in some cases the non-profit sectors in certain jurisdictions (Wallis, 1997; Dale and Pale, 1998; Mason, Kirkbride and Bryde, 2006; Millar and Abraham, 2006; Chhotray and Stoker, 2009). This is partly attributable to what Irvine (2007, p.1) termed “corporate creep”, as reflected in the growing use of professional consulting providers in the non-profit sector and the growing pressures on such organizations to adopt corporate systems (Irvine, 2007, p.27) and in the push in the public sector for restructuring and reform based on agency principles.

Criticisms of agency theory in the context of corporate governance have been largely directed at the economic assumptions that underlie it. The most important of these are (a) the premises on which it relies are too narrow, (b) the theory neglects the salient non-economic influences on management decisions and actions (Mason, Kirkbride and Bryde 2006; Donaldson and Davis, 1991; Davis, Schoorman and Donaldson 1997), (c) it implicitly assumes the manager is untrustworthy and therefore must be controlled (Mason, Kirkbride and Bryde 2006; Campbell 1997), (d) the focus on overall shareholder value ignores the reality of a highly complex corporate picture of investment (Smallman, 2007) and (e), it denies the important role corporations play in the wider social and economic settings (Donaldson and Preston, 1995). It also does not offer any explanation how sustainability of a firm is covered through the agency costing mechanism.

The second theory (or rather two related ones) stems from agency theory and highlights the importance of costs and their calculation in identifying efficient and effective governance structures while relying on the same assumptions of self-interest as does agency. This theory, transaction cost economics (TCE) is introduced below.

The other theories (explored below) stand as contrasts to agency. As a preliminary point, all of them see the firm (or corporation) as a player in a broader social context rather than as a nexus of logical (and limited) relationships (Christopher, 2010). This broader role implies first, that the range of relationships for a firm is both complex and subject to constant change in a volatile market environment (Clarke, 2007). A second implication is that good governance is contextual: dependent on such factors as culture, size, ownership and the wider environment (OECD, 2004, Sison, 2000).

Stakeholder Theory

By way of general introduction, advocates propose that instead of the firm being seen as having one overarching objective (the maximisation of shareholder wealth (Coelho, McClure and Spry, 2003)), it should instead be located as a social actor responsible either legally or morally (or both) to a range of internal and external constituencies. These stakeholders can be human or non-human; direct or indirect and herein lies one of the major problems: the location and ranking of such stakeholders.

In addition, although the term stakeholder is used extensively by a wide range of organizations even outside business (public sector, local government and central government being only three), the broad range

of definitions offered (see, for example Brenner and Cochran, 1991; Clarkson, 1995; Donaldson and Preston, 1995; Freeman and Reed 1983; Freeman, 1984; Mitchell, Agle, and Wood, 1997; Tsogas, Komives and Fuller, 2005; Waddock, 2002) it has been criticised (for example Kaler, 2002; Waxenberger and Spense, 2003) as vague and uncertain; doing little to assist organizations in evaluating and balancing conflicting demands that might be placed upon them.

Writers such as Donaldson and Preston (1995), Freeman (1994) and Freeman, Wicks and Parmar (2004) have addressed this particular problem; Freeman, for example, classifies shareholders, suppliers, employees, customers and the community as ‘the big five’ (Freeman, 1994) members of the category of ‘those groups and individuals who can affect (or be affected by) [business activities]’ (Freeman, Wicks and Parmar, 2004) while Mitchell, Agle and Wood (1997) propose a multi-faceted theoretical framework to establish the ‘principle of who or what really counts’ (Mitchell, Agle and Wood, 1997, p.853).

In the context of corporate governance, advocates for stakeholder theory claim that ‘it is the firm’s objective of unalloyed shareholder value-maximisation that leads primarily to a micro failure of governance arrangements’ (Keasey, Short and Wright, 2005, p.3). The stakeholder perspective recognises that there may be multiple principals (shareholders) with heterogeneous interests and objectives. In addition, proponents consider the range of stakeholders to include, but not be limited to, owners or investors, thus offering a range of multiple stakeholders with divergent interests, including employees, customers, suppliers, creditors and lenders and the wider community (Jensen, 2007). Given the difficulties inherent in implementing governance strategies that protect each and every one of these divergent stakeholders’ interests, the stakeholder perspective requires that, rather than remaining preoccupied with protecting shareholder interests, governance structures ought to focus instead on the long-run value of enterprises (George, 2010; Bhimani, 2008). This assumes, somewhat speculatively, that long-run sustainability of an enterprise in itself is proof that stakeholders have become unified in their support of the firm.

Of interest in this context is the recent reporting by Brammer, Jackson and Matten (2012) of evidence emerging from a European retail context that stakeholder-driven initiatives are threatened by what are described as “business-led” initiatives. This might at first sight suggest that agency theory and its implicitly shareholder-interest supremacy approach is the best approach to governance. Yet, as these authors go on to explain, “business-

led programmes are often and increasingly dependent on the involvement of external stakeholder groups in order to bolster their external legitimacy” (Brammer et. al, p16). This finding suggests that, while some firms may firmly adhere to the contractualist approach they also apply stakeholder principles as a means of expanding and securing their wider support base.

Despite growing evidence as to the importance of stakeholders in driving corporate strategy, the body of researchers advocating a stakeholder approach, as well as approach and focus in non-profit and public sector organizations, there is no shortage of critics, including those who point to fuzziness and uncertainty in recognising and managing the various interests. Leading the charge are those who maintain and argue that insisting that a corporation is accountable to a diversity of potential stakeholders instead means it is accountable to no-one, with no-one able to enforce that accountability.

Somewhat compatible with the stakeholder perspective is stewardship theory that emphasises that those responsible for managing an enterprise should (and largely do) see themselves as stewards entrusted with the ambitions, needs and wants of those who rely on their expertise and knowledge. This theory and its implications are explored below.

Stewardship

In many ways this theory contrasts with the more prescriptive nature of agency theory, and has had little impact upon corporate governance research or measures designed to improve it when compared with agency theory and transaction cost economics (Cadbury, 1992; Financial Reporting Council, 2003; Greenbury 1995). However, it is useful to compare its approach in terms of what it implies for governance of companies.

Muth and Donaldson (1998) describe the stewardship model as one ‘based on manager as “steward” rather than the entirely self-interested rational economic man of agency theory’ (Muth and Donaldson, 1998, p.5-6). Mason et al. (2007) agree, explaining stewardship theory as ‘present[ing] a view of governance that diverts from economic interpretation of relationships within an organization’ (Mason et al., 2007, p.290). Instead, it recognises physiological and situational factors. Physiological factors include identification and power while situational ones include management philosophy and power. Mason et al. (2007) (a view echoed by Davis, Schoorman and Donaldson, 1997 and Lockhart, 2007) stress that trust is implicit in such a model because managers are assumed to take the necessary steps to maximise the interests of the organization, and

Donaldson and Davis (1991, p.51) state that it also assumes that generally managers aspire to do a good job.

Arguably, such an approach envisages the organization as an organic being reflecting a nexus of interests (as opposed to a structure offering a nexus of contracts as in the instance of agency theory). It is the responsibility of management to recognise and mediate between those interests so as to maximise overall satisfaction. Stewardship theory therefore premises that structures within the company should be designed not so much to control but to enable (Olson, 2008). This requires the understanding by various participants of the respective interests and the development of a coping mechanism by which those interests are recognised and harmonised. Admittedly, this is a challenging presumption during time of governance stress, e.g. when complex governance decisions about cessation of trading, changes in shareholdings and other material corporate events are made, although Segaro (2012) argues that in the case of family-run and owned SMEs, stewardship principles “moderate the curvilinear relationship between family ownership and internationalisation. Specifically, higher levels of stewardship orientation strengthen the relationship” (Segaro, 2012, p.155).

The above is perhaps an important point given the critique levelled against stewardship theory by Albanese, Dacin and Harris (1997) in the course of a debate with Donaldson et. al, in which they argue that stewardship assumes that content of preferences for actors is more important than the principle of rationality itself and that rationality as defined by stewardship advocates is a bounded concept remote and unaffected by any other considerations or factors (such as trust, relationships or underlying ethical constructs) and therefore inevitably assuming narrow, self-serving and extrinsic outcomes for such actors.

Instead, they suggest, the robustness of agency theory lies in its determination to assume individuals make decisions about preferences in a rational fashion (ie, make those choices that maximise individual utility). However, this does not preclude or deny that the factors that shape the utility are subject to other factors such as personal preference, relationships or ethical beliefs.

However, an alternative viewpoint on the relationship of these two theories is to see them not as opposites but as complementary, or as Elsayed (2010) explains:

**the assertion of both agency theory (CEO non-duality structure)
and stewardship theory (CEO duality structure) may be valid**

under certain conditions. Thus, existing theories might need to be treated as complementary viewpoints, each of which draws upon a part of the whole picture, because depending on just one single perspective is more likely to result in misleading conclusions about the structure as a whole” (2010, p. 80)

This perspective is interesting as it throws open the entire question as to whether and in what circumstances is the mantra of separation between board and CEO truly valid and necessary.

A third theoretical framework standing in contrast to agency is institutional: a theory that takes institutions, rules and context into account when seeking to judge the efficacy or otherwise of any particular structure.

Institutional Theory

In institutional theory, ‘institutions consist of cognitive, normative, and regulative structures and activities that provide stability and meaning to social behaviour. Institutions are transported by various carriers – cultures, structures, and routines – and they operate at multiple levels of jurisdiction. Institutions are composed of cultural-cognitive, normative, and regulative elements that, together with associated activities and resources, provide stability and meaning to social life’ (Scott, 1995, p. 48). There are two main strands, “Old” Institutional Theory that places the organization at the centre of the discussion as the institution (Selznick, 1996; Leaptrott, 2006) and focuses on the “purposive efforts of individuals to respond to environmental pressures” (Leaptrott, 2006, p. 216); and “New”, the strand that shifts attention from the company as the institution to the cultural context in which companies operate. External and internal social and political influences (including status, group, reputation, ideology and power) (Rutherford, 1995) are then important in both describing and evaluating corporate governance structures. It draws on organizational theories and the social, political and economic role of the firm to understand and formulate governance “aligned with the concepts of citizenship, participation and legitimacy” (Parkinson, 2003, p.491).

In the context of corporate governance, institutional theorists would maintain that it is not possible to appreciate corporate governance at all without also appreciating the broader economic, social and political environment. In Enron’s case, for example, those broader economic (deregulation of the electricity market and lax audit requirements); social (within the organization a culture of greed, laissez-faire leadership and outside it an atomistic focus) and political (celebration of the market,

political cronyism and the value attributed to the large business organization) characteristics of the environment allowed and encouraged the rot to set in.

More broadly, Li and Harrison (2008, 2008a) in their papers on corporate governance of multinational companies, argue that research into governance has failed to consider the wide variation in governance structures across countries and by assuming consistency fail also to offer useful insights into how governance can be improved. This vexing issue of comparison across different systems has also been raised by Li (1994, 2007), Cioffi (2000), O'Sullivan (2003) and Aguilera and Jackson (2003).

In the context of governance, Selznick (1996) explains that this theory is “a voice of resistance to [a]...culture of short-sightedness, offers guides to thinking about corporate responsibility, and brings into question the goal of maximising profits or returns on capital” (Selznick, 2006, p. 272). Instead of treating the corporation (or company or firm) as a passive nexus for enabling contracts between self-interested economically rational beings (the basis of agency theory), institutional theory gives it a much broader role as an adaptable social system (Mason, Kirkbride and Bryde, 2007), thereby also empowering those involved in such organizations to respond to other groups within that organization and outside. The theory subsumes stakeholder theory (Parkinson, 2003) with its assumption that stakeholders of various types, power and location affect both formal and informal processes within the organization, and further acknowledges that stakeholders (or more generally participants) have a culturally-oriented impact on the institutions that control behaviour and reward outcomes.

Institutional theory also has a reflective function in the context of corporate governance in that it can inform institutional design (Harriss, Hunter and Lewis, 1997, p. 2). More generally, there is implicit acceptance that a framework of formal ‘rules’ may be the best option within a particular cultural or economic context to cope with market failure (Harriss et al., 1997). Such failure could be found in a weak equity market (where participants are unrestrained in their misuse of information – insider trading), cultural norms or where weakness of the economy and its vulnerability to domination by transnational business organizations prompt a Government to respond with changes to formal rules – including regulations criminalising certain market behaviours, providing import controls or offering other sorts of protection (including minimum and maximum incomes, levels of foreign ownership or other participation in business (Nwabueze and Mileski, 2008). Finally, as Mason et al., (2006) explain, in incorporating informal

restraints, the theory immediately moves beyond the boundaries assumed by agency theory (that the contracts between the agent and principal will be determined by agreement and enforcement/control) to look at other relevant factors.

A second departure from agency theory relates to the treatment and nature of choice. A fundamental assumption for agency theory is that individuals make decisions based on rationality (basic cause and effect) (Albanese, et al. 1997), primarily economic. The sum of such choices then becomes the choice of the collective. By way of contrast to agency and its focus on rational choice, institutional theorists argue that choice is multifaceted because ‘ideas and ideologies’ also play a part (consistent also with post-structural ideas of a human as a social product, shaped by his or her socio-temporal environment (Foucault, 1973). Institutions may reduce the levels of uncertainty that might otherwise result from those ideas and ideologies (North, 1997) but does not eliminate them. According to Rutherford, (1995), Commons (1934) takes the matter of ideology further, presenting its evolution as a process of modification to ‘habitual assumptions’ (Rutherford, 1995, p. 445) – a manifestation of social learning without which no progress would be possible.

Therefore, if the influence of those ideas and ideologies is such as to prompt a decision-maker in an organization, including a corporation, to reach the conclusion that maximising the satisfaction of members and outside groups is achieved through increases in charitable donations or sponsorship of the arts, it is difficult to then conclude that economic rationality is paramount (in accordance with pure economic theory anyway although Jensen and Meckling (1976) might argue differently). However, ignoring these other facets to the decision-making process will not make them go away.

Overall, it is claimed that institutional theory offers a rich alternative to the narrow-minded, static approach offered by agency theory (Letza, et al., 2008). By drawing on a range of social science disciplines (including sociology, psychology, economics, law, politics and others) it is possible to increase understanding of what motivates individuals and groups within an organization (Van den Abeele, 2007); explain how and why managers and directors make decisions (Yiu and Makino, 2001; Campbell, 2007), thereby ensuring appropriate process and structure; explore the role of ideologies, ethics, power and personalities in determining direction and decisions within hitherto univocal groupings (Letza et al., 2008; Li and Harrison, 2007; Mason et al., 2007; Mtar, 2010); create robust models

for governance in different settings and for different purposes (Mason et al., 2007, Nwabueze and Mileski, 2006; Bates, 1995) and establish the institutional mechanisms to maximise individual and social welfare (Kahn, 1995; Jwa et al., 2000).

However, not everyone is positive about the contribution to governance research offered by institutional theory. First, and as a general point, it should be noted that certain of the criticisms levelled against stakeholder theory also can be levelled against institutional theory. For the proponents of shareholder theory (Friedman, 1970), the danger posed to business through the diffusion of responsibility and the difficulty of establishing with any degree of assurance, exactly who or what factors or interests should be considered of importance to governance.

Other criticisms are more specific to institutional theory, to its different strands and to its application or use. General criticisms include persistent conceptual confusion (Peters, 2000). Also, there is lack of consensus as to how individuals interact with institutions in making judgments about policies and actions. While, as Peters points out, March and Olson (1989) 'argue vigorously' (Peters, 2000, p.5) that preferences are affected by the person's experience with the institution (endogenous), others argue that they are exogenous or not affected by any such experience. In addition and as also indicated above, there are different meanings applied to institutions themselves – from old institutional theory with the focus on the organization as a formal institution and the new – with its far broader and less distinct meaning.

Finally, Aguilera and Jackson (2003) are of the opinion that while institutional theory is a response to the 'under socialised' characteristic of agency theory (as being overly dismissive of "institutional embeddedness" and its effect on corporate governance), they consider that institutional theory suffers by dint of going to the other extreme – that it is 'over socialised' (its model or models too abstract to deal with conflicts and cooperation at firm level). In seeking means to make institutional theory concepts work (their particular focus being the different corporate governance structures and practices in different jurisdictions), they prefer an 'actor-centred' approach; hence governance will be the function of the characteristics, interactions and preferences of these three stakeholders but also as moderated and influenced by institutional factors.

The above discussion clearly signals the importance placed on strategies and mechanisms to maximise the performance and responsiveness of management of organizations (especially companies). While it is

acknowledged that the main group with an interest is this responsiveness is that of the owners (normally shareholders) institutional theory in particular acknowledges also that other groups are affected by the organization and in fact it may not be in the company's best interests to ignore that. Institutional theory also posits that such consideration is not only an expectation but a given – the economic rationality assumed under agency theory is coloured by political, social and behavioural considerations.

The final theory to be explored is resource dependence or dependency theory (Pfeffer and Salancik, 1978; Christopher, 2010; Muth and Donaldson, 1998). This theory uses as a central focus the idea that a corporation or other organization is a means of bringing together a range of resources: the challenge is maximising their use and benefit.

Resource Dependence Theory

A theme that emerges again and again, no matter what the theoretical construct, is that in the interests of good governance, boards should protect the interests of owners not only by way of selection of CEOs and monitoring management conduct but also, and perhaps more importantly, by determining strategy and providing and exploiting vital resources that will permit the company to thrive and grow (Bennett and Robson 2004; Gabrielsson and Huse, 2005).

To enable this wide range of functions to be executed this theory assumes that the board have at its disposal expertise, experience, networks and contacts, and skills and, if not, will take the necessary steps to acquire them (Muth and Donaldson, 1998). This range of resources is described as 'board capital' (Christopher, 2010) but, he also points out, is largely ignored by agency theory with its focus on monitoring.

The questions then arise: How does a board acquire the necessary skills, expertise and experience, and what does that say about the constitution and size of a board in any given situation? Pfeffer (1972) and Pfeffer and Salancik (1978) explains that a board looking to satisfy its vital governance functions will look to attract directors who can contribute: Whether that contribution supports that provided by existing members or offers new and innovative skills or other advantages. In a sense similar to the situation under stewardship theory, once a new member is on the board, the organization 'expects the individual will come to support the organization, will concern himself with its problems, will favourably present it to others, and will try to aid it' (Pfeffer and Salancik, 1978). The proof of the benefits arising

from such aid and support comes in improved firm performance (Dalton, Daily, Ellstrand and Johnson, 1998; Pfeffer, 1972) and, theoretically at least, the constitution and size of the board will be optimal for the purpose: a small firm might rely on very few multi-skilled members while a large may realise growth and innovation by way of a well-resourced board boasting a range of talents and connections (Christopher, 2010).

It is also possible to suggest that the selection of a manager that can enrich the resources available to the board may also improve firm performance (Christopher, 2010; Toms and Filatotchev, 2004). In such an instance, the gap between the board and manager so carefully cultivated by agency theory may be narrowed in the overall interests of the firm.

The overall interests of the firm are also the focus of the last of the theoretical frameworks to be discussed (albeit briefly), this being the relatively new Entity Maximisation and Sustainability model or EMS (Keay, 2008, 2010).

Entity Maximisation and Sustainability Model

Keay justifies this model by reference to those problems (described above) that plague agency theory (and its focus on some single shareholder priority) and stakeholder theories. His new model then seeks to address these problems and criticisms by way of two distinct elements. The first of these is a commitment to maximize the entity (by enhancing the company's wealth but not necessarily via profit maximization). This element is important in that it shifts the focus from measuring profits (an essentially short term focus) to longer term wealth, a shift that not only potentially benefits shareholders but also addresses the concerns of the broader diversity of stakeholders such as employees, debt holders and the community. The second element of the model is sustainability (in this particular context used only to refer to the financial survival and prosperity of the company) (Keay, 2008) thereby encouraging and authorizing decision-makers to strategize to ensure the company's endurance as a going concern. This second aspect is important as it challenges some of the essential premises around the company form – that it is merely an abstract vehicle for investors and other contractors to enter into mutually convenient legal arrangements (Jensen and Meckling, 1976) – and instead acknowledges the concept as a separate entity not only at law but also in wider social discourse.

The positive consequences identified for the company and its constituents (shareholders and others) include avoiding short-term cost-cutting or

revenue-enhancing policies (such as cutting employee numbers, scrimping on health and safety, asset sales and risky ventures) and instead focusing on the longer-term (reputation enhancement, community-level investment, research and development and employee training and education) (Keay, 2008).

By way of summary then, Daily et al. (2003) explains that ‘the overwhelming emphasis in governance research has been on the efficacy of the various mechanisms available to protect shareholders from the self-interested whims of executives’ (Daily et al., 2003, p. 371). However, governance is not just about management decision-making. Rather it can be argued that its underlying purpose has long been much broader – encompassing the range of steps and strategies that are instrumental in improving company performance.

Chapters in Part 1

The chapters that are included in this part explore aspects of the theories around corporate governance, reflecting on how they are applied, issues around their application and applicability and offer arguments as to whether and how they should be promoted as offering the answers to the governance dilemmas that arise.

The first two chapters in this section present quite different views on the same issue: whether companies ought to consider stakeholders and/or CSR when determining strategic direction. Cavico and Mujtaba (in **chapter 3**) offer an in-depth analysis of what companies are doing in cultivating stakeholders and a rationale for them to develop and incorporate CSR principles in their decision-making. In particular, they argue that increasingly it makes sense for companies to be socially aware and responsive as a means of ensuring long term prosperity and sustainability of the business. Further, and by way of assistance to those seeking to pursue such a strategy, the authors offer tools that might be applied.

By way of contrast, in **chapter 4** Machan argues that stakeholder and CSR principles have no or little place in business, particularly where they shift the foci of the company and its decision-makers from the prosperity of the company and the shareholders to other groups and interests. Machan argues that legally requiring or mandating such a broader focus is both coercive and contrary to the rights of investors and shareholders to choose how to use and /or allocate their resources.

Other chapters develop aspects of this theme. Using the example of an American Health Care provider, Martin (in **chapter 5**) explores further the

potential conflicts that can arise between the contrasting values that drive decisions by those responsible for governance of business organizations. He makes the point that decisions that might reduce costs and increase profitability might also ironically militate against the very values for which such an organization purportedly stands and raise questions as to the extent to which it can portray itself as an integral and valued part of the social structure.

In **chapter 6** Marais and Vorster examine the growing pressure for a particular utility company, Eskom, to be accountable to its stakeholders rather than just to its shareholders. Based on their analysis, they conclude that at the rational level, Eskom addresses most of the identified stakeholder groups and their interests associated with the triple bottom line. At the transactional level, Eskom follows a strategic posture of engagement, dialogue and negotiations towards its stakeholders. At the process level, the utility's integrated reporting process manages the needs and expectations of stakeholders. Their overall conclusion is that Eskom does by and large follow a 'stakeholder-inclusive' approach to corporate governance.

The next chapter in this section (**chapter 7**), by Jeong, is more specific, addressing as it does the governance challenges faced by the Boy Scouts of America when seeking to address the question of whether the openly gay should be permitted to be members and/or leaders within the organization. The essential issue in this particular case revolves around its social location and responsibility – whether reflective of and answerable to society as a whole (and therefore subject to its anti-discrimination and other rules) or whether bound by its traditional religious values.

Finally, **chapter 8** (provided by Jakisch) has a different focus again, exploring and cogently arguing for the value of IT-based frameworks in supporting robust corporate governance and strategy. His rationale is persuasive: corporate governance steers and controls the corporate environment. Linked to an internal control system, it manages performance and compliance. Management systems that are IT supported and under the control of IT departments must be able to extract information and produce/compile reports that are meaningful to business management. A clear interdependency between business and IT is the result.

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Chapter 3

Social Responsibility, Stakeholders, Sustainability and Corporate Governance

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Abstract

Stakeholder analysis has emerged as a critical concern for the modern business leader. Typically, stakeholder considerations, above and beyond the interests of the shareholders of the corporation, have been interpreted and examined under the concept of “corporate social responsibility.” Corporate social responsibility (CSR) now also has become a central issue for business leaders. Moreover, today stakeholder analysis as well as CSR is converging with the notion of “corporate governance,” which traditionally has had mainly legal connotations. In this chapter, the authors examine stakeholders and CSR in the context of corporate governance. The critical relationship of corporate social responsibility and stakeholders to corporate governance is emphasized and explicated. The authors examine the many definitions given to the term “social responsibility” and further examine these definitions as they are applied to modern day business. Social responsibility is differentiated from legality and ethics. Modern day business examples are provided on a global basis of companies and organizations being socially responsible. The relationship of social responsibility to corporate constituency statutes and the social benefit corporation is addressed. The authors provide rationales for a company or organization to be a socially responsible one. The authors in so doing underscore the smart, shrewd, and strategic value for an entity to engage in prudent social responsibility activities. In order to help companies and organizations to be socially responsible, the authors provide a Stakeholder Value and Social Responsibility Table as well as a Business Sustainability Continuum. Finally implications and recommendations for business leaders are provided to incorporate not only legal and ethical values, but also corporate social responsibility and stakeholder values into corporate governance. Thought-provoking discussion questions are provided for academic and corporate training purposes.

I. The Values of Legality, Morality, and Social Responsibility

When one initially encounters governance, social responsibility, and stakeholder analysis in a business context, there can be some confusion due to a lack of an agreed-upon terminology and set of definitions. What is social responsibility? How does it differ from the law, ethics, and morality? What exactly do “corporate social responsibility,” “stakeholder values,” “sustainability,” “people, planet, and profits,” “going green,” and “socially responsible investing” mean? What is a corporate “constituency” statute and how does it compare and contrast to a “social benefit” corporation? If one is going to understand what social responsibility is and how it works in a modern global business environment, there must be some agreement on, and some insight into, the meaning and nature of the value of social responsibility especially when juxtaposed with the values of legality, based on the law, and the value of morality, based on ethics. In order to arrive at a precise as possible meaning of the term “social responsibility,” it is first necessary to define some fundamental terms and concepts. A value is something that possesses worth. Values can be intrinsic (also called terminal), meaning that they possess value and worth in and of themselves, for example, happiness; whereas values that are “merely” extrinsic (also called instrumental) possess worth and are valuable because they are the means to produce something else of value, for example, money (which can buy happiness!). The value of legality is, of course, based on the law while the value of morality stems from ethics, yet the terms are not synonymous. Morality is the conclusion of what is right or wrong or good or bad whereas ethics is the philosophical framework, consisting of ethical theories and principles that one uses to reason to moral conclusions. Whether morality is an intrinsic value or merely and instrumental one is an issue which the authors will leave to the philosophers. Social responsibility too is a value, related to, but distinct from law and ethics.

II. Corporate Social Responsibility

Social projects and social welfare in the United States traditionally have been viewed as the appropriate domain of government and benevolent organizations, not of business. Business, of course, is taxed and such taxes may be used for social purposes, but the traditional purpose of business as viewed in the U.S., moreover, is the profitable production and distribution of goods and services, not social welfare.

What exactly is a corporation’s “social responsibility”? Does a corporation have a social obligation to take care of the poor, educate the

public, give to charity, and fund cultural programs? The concept of the social responsibility for business was first introduced by the prominent scholar, Adolf Berle, in his 1932 text, co-authored with Gardner Means, *The Modern Corporation and Private Property*, a work that explored notions of community and stakeholder interest, service to the public, “trusteeship” to non-shareholder constituencies, stabilization of business, as well as a broader social understanding of corporations. This seminal book raised the question of whether corporations owed a duty of “trusteeship” to constituencies or stakeholders other than shareholders. This issue is now a critical one for business today.

Accordingly, what is the “social responsibility” of business today? The term at a basic philanthropic level may be defined as a business taking an active part in the social causes, charities, and civic life of one’s community and society. Newman’s Own is a private sector company praised for its philanthropic mission since it donates all of its profits and royalties after taxes for charitable and educational purposes. However, corporate social responsibility (CSR) certainly can be more than “mere” philanthropy. The social responsibility of business can also be thought of in a broader constituency or stakeholder sense, that is, by the corporation considering the values and needs of employees, suppliers, consumers, local communities, and society as a whole. One can also take a “strategic” as well as stakeholder approach to corporate social responsibility by integrating stakeholder, social, environmental, as well as economic concerns into the organization’s values, culture, governance, strategy, and decision-making.

The World Business Council for Sustainable Development views social responsibility in a corporate context as a company’s continuing commitment to act legally and morally and also to contribute to the economic development of society while improving the quality of life of their employees and their families as well as the local community and society as a whole. This definition evokes another, and even more expansive, concept of the “social responsibility” of business – “sustainability.” The sustainability approach to corporate social responsibility is premised on the idea that a company must remain economically viable in the long-term, and that in order to be viable the company must take into consideration other stakeholders beyond the shareholders. The objective is to simultaneously produce economic value for the company, but also value for society as a whole by helping to solve societal needs, particularly by improving the lives of the people (and potential consumers) who live in the communities where the company does business. “Sustainability” is often used when discussing

such concepts as corporate citizenship, social responsibility, stakeholder analysis, and social enterprise.

Corporations clearly have size, stature, wealth, and power. Some in the U.S. now have been deemed “too big to fail.” Moreover, that power has been markedly increased in the United States by a recent Supreme Court decision allowing corporations to support candidates and causes (though not to give directly to candidates or political parties). With great power comes great responsibility. Accordingly, if a corporation does seek to engage more in the political process by means of contributions, lobbying, endorsements, and support, then there is an expectation that such a “democratic” entity will act in a responsible manner, including, of course, in a socially responsible manner. Yet, there is a more “Machiavellian” side to sustainability in the political realm. That is the use of social responsibility as an instrument for corporate aggrandizement through subsidies and grants from government, obtained by lobbying and political connections and contributions, for “green” projects. These “favored” projects, such as wind and solar energy, electric vehicles, and energy from algae, may not be financially viable on their own, but are immensely lucrative with the government largess. And if a “green” project fails it is only the taxpayers that are “on the hook.” So, the corporation sustains itself by “going green” in the sense of securing a socially responsible reputation and also is insulated from any economic losses by the government. Yet, and not to be overly cynical, there may be the expectation of a quid quo pro in the form of corporate contributions and support to “green” candidates and causes. This mutually beneficial between corporations and government typically is called “crony capitalism” or, by conservative commentators, “crony socialism.”

A corporation, of course, is a profit-making entity that exists in a competitive environment, and thus may be limited in its ability to solve a multitude of social problems particularly at the expense of the owners of the corporation – the shareholders. Where are the philanthropic guidelines for corporate contributions and improvements? How should a corporation’s resources be allocated, and exactly to whom, to what extent, and in what priorities? What is the proper balance between shareholder and stakeholder interests? The corporate governance policies of the organization must seek to answer these important, yet, difficult questions. If a corporation unilaterally or too generously engages in social betterment, it may place itself at a disadvantage compared to other less socially responsible business entities. Being socially responsible costs money, and such efforts cut into

profits. In a highly competitive market system, corporations that are too socially responsible may lessen their attractiveness to investors or simply may price themselves out of the market. One example is the clearly socially responsible firm – Ben & Jerry's, which has long been known and lauded for its civic, community, and environmental efforts. Yet the company may have been too socially responsible and consequently neglectful of basic business concerns. Ultimately, the original former “hippies” Ben Cohen and Jerry Greenfield of Ben & Jerry's sold their interests in their company in 2000 to global consumer products giant, Unilever, which carried on the social responsibility activities of the brand to a degree, but in a more prudent and strategic manner.

Nevertheless, despite the saga of Ben & Jerry's, social responsibility, at least to some reasonable degree, may be in the long-term self-interest of business, so long as these activities align with the corporation's long-term objectives. Furthermore, there is some evidence that these socially responsible strategies have been successful. For example, Wang and Qian (2012) conducted a study of the philanthropic of publicly listed Chinese firms from 2001 to 2006 and found that corporate philanthropy enhances corporate financial performance by enabling firms to elicit better stakeholder responses and to gain political resources. Tyagi (2011, p. 31) reports on studies that support the proposition that corporate social responsibility positively affects “corporate attractiveness.” Afsharipour (2011), furthermore, reported on an Indian study that revealed a positive relationship between company performance and corporate social responsibility. Maggins and Tsaklanganos (2012, p. 663) reported on a series of studies that indicated that corporate social responsibility is significant in corporate decision-making because of the relationship between a firm's social responsibility policies and actions and its financial performance.

A corporation cannot long remain a viable economic entity in a society that is uneven, unstable, and deteriorating. It makes good business sense for a corporation to devote some of its resources to social betterment projects. Of course, to posit that a corporation should engage in social responsibility activities raises the related questions of where and how it should spend its money. As such, should the corporation engage in local community projects and charities in communities where its employees are located, for example, by donating to the local museum or sponsoring an arts festival, or should the corporation engage in broader activities, such as AIDS prevention in Africa, where the company might gain more exposure and positive publicity? These are key questions that will have to be answered, the authors

recommend, in a smart, shrewd, and strategic manner by the corporation. Tailoring social responsibility to fit the needs of current and prospective employees is, obviously, a beneficial as well as egoistic rationale. To operate efficiently, for example, business needs educated and skilled employees. Education and training, therefore, should be of paramount interest to business leaders. A corporation, for example, can act socially responsible by providing computers to community schools and by releasing employees on company time to furnish the training. Business also gains an improved public image by being socially responsible. An enhanced social image should attract more customers and investors and thus provide positive benefit for the firm. Maggins and Tsaklanganos (2012, p. 661) that in 2007 64% of Fortune 100 companies published a social responsibility report which described their economic, environmental, and social performance. Afsharipour (2011) points to evidence from India that indicates that being perceived as a socially responsible firm will result in an enhanced public image and improved customer satisfaction. Tyagi (2011, p. 31) reported on a global survey of over 1000 corporate executives conducted by the Economist which indicated that executives perceived business benefits of corporate social responsibility because CSR “...increases attractiveness to potential and existing employees.” Afsharipour (2011) related the comments of high-level executives of Indian companies who believe that companies with corporate social responsibility programs, particularly employee-driven ones, will increase employee pride, satisfaction, loyalty, retention, and productivity. Christopher and Bernhart (2009) reported on studies that demonstrated the recruitment and retention benefits of social responsibility, for example, a study indicating that 64% of employees indicated that corporate social responsibility (CSR) activities increased their loyalty, and that 90% of employees would choose an employer viewed as more socially responsible. Christopher and Bernhart (2007) also indicated that a meta-analysis of over 50 studies found corporate social responsibility components, including treatment of employees, significantly affected financial performance measures; and, more generally, objective corporate social responsibility performance ratings were found to be significant predictors of employer attractiveness to potential job applicants.

Business Week (Marketing, 2012) recently provided examples of companies engaging in socially responsible marketing as one way to persuade consumers to spend in a difficult economy, to wit: Sketchers USA launched a brand called BOBS, meaning Benefiting Others By Shoes, the company donating two pairs of shoes for every one sold; Urban Outfitters

features clothes by Threads for Thought, which gives part of its sales proceeds to humanitarian groups; Nordstrom sells hats made by Krochet Kids International, which enlists impoverished people in Uganda and Peru, for example, to make hats which are sold in the U.S. for \$24; and Feed Projects, which makes T-shirts, handbags, and accessories, donates a percentage of its profits to United Nations anti-hunger programs. When implemented correctly, these socially responsible retailing efforts are “good works” and also good strategies, which may be young consumers who may not have the means to make large charitable contributions but who admire brands that are “trendy” but which also reflect a save-the-planet theme. To further illustrate, the Walt Disney Company, in an effort to portray a socially responsible message, as well as to attract customers to its theme parks, commenced a program, called “Give a Day, Get a Disney Day,” whereby the company will give away a million one-day, one-park tickets to people who volunteer at select charities.

A corporation that acts more socially responsible not only secures public favor, but also avoids public disfavor. To illustrate, for many years the large multi-national pharmaceutical companies were criticized for not providing AIDS drugs for free or at greatly reduced prices to African governments. In response to public criticism, the pharmaceutical responded in a socially responsible (and also egoistic manner) by giving the drugs away or selling them at cost. Moreover, certain pharmaceutical companies, such as Roche and GlaxoSmithKline, on their social responsibility and sustainability websites, have statements indicating preferential pricing and accessibility as well as limited patent policies for AIDS drugs going to African and other less developed countries (Roche, 2007; GlaxoSmithKline, 2005). Accordingly, social responsibility and also good public relations are achieved. For example, the Coca-Cola Company has been praised for aiding the AIDS effort in Africa. Even if the giant pharmaceutical companies do not have the global reach to deliver AIDS drugs to the remotest African village, Coke can and does (along with its soda products, of course)! Yet companies, and now including the Coca-Cola Company, must be careful about public relations overall, because, in Coke’s case, the company is now being criticized for contributing such issues as child obesity and damage to ground water supplies and quality in India where it has established processing and bottling plants. Another always controversial example is Wal-Mart, the giant retailer, which in response to criticisms from environmentalists and labor activists, now has a director of global ethics, who will be responsible for developing and enforcing company standards of

conduct, as well as a “senior director for stakeholder engagement,” whose role will be to develop a new model of business engagement that produces value for society. Similarly, clothing and apparel manufacturers, such as Nike and the Gap, in response to criticism by labor and consumer groups about exploitive working conditions in overseas “sweatshops,” have ended poor working conditions, and now also report on their social responsibility efforts and achievements overseas. Business is part of society and subject to society’s mandates; and if society wants more “responsibility” from business, business cannot ignore this “request” without the risk of incurring society’s anger, perhaps in the form of higher taxes or more onerous government regulation. Socially responsible activities may also improve a company’s reputation when viewed by external stakeholders, such as bankers, creditors, investors, and government regulators, which not only may avoid economic harm, but also may bring about economic benefits. As such an egoist and rational actor will surely see the instrumental value of a prudent degree of social responsibility in today’s global business marketplace.

The topics of social responsibility and stakeholder analysis emerged as a critical one for global business leaders too. However, the interpretation and application of corporate social responsibility will vary from country to country, industry to industry and company to company due to different local conditions and the different values and needs of stakeholders in different countries. The prevalence of corporate social responsibility (CSR) on a global basis has been illustrated by a survey conducted by the Society of Human Resource Management (SHRM) in 2007 (Workplace Visions, 2007). SHRM found that a majority of Human Resource professionals in the countries surveyed (United States, Australia, India, China, Canada, Mexico, and Brazil) reported that their organizations had corporate social responsibility practices in place. A global example would be the Coca-Cola’s company’s efforts to provide clean water to parts of the developing world (although see reference above to India and the concerns that are being raised there), which Coke also hopes to promote goodwill, boost local economies, and broaden its customer base. Royal Caribbean Cruise Company is teaming up with a Haitian non-profit organization to build a primary school, which is located on land the company leases from the government as a stop for its ships in the port town of Labadee. Wal-Mart is now selling online handicrafts made by women artisans in developing countries, such as dresses made in Kenya and jewelry from Guatemala and Thailand. Over 500 items from 20,000 female artisans

will be offered for sale, which certainly will help the female artisans but also improve the company's global image. "Sustainability" is also used to support corporate social responsibility efforts globally: "For transnational corporations doing business in developed countries, sustainability may require investment in community-level infrastructure development projects, technological innovation, education, and health care. As these investments lead to greater productivity and better product quality, workers and producers can earn higher incomes, allowing the local population to enjoy a higher standard of living" (Millon, 2011, p. 531). Two excellent examples of global "sustainable" CSR are: 1) The Norwegian company, Yara International, the world's largest chemical fertilizer company, has sponsored public/private partnerships to develop storage, transportation, and port facilities in parts of Africa with significant untapped agricultural potential, thereby developing local agriculture, providing jobs and improved incomes for farmers, and at the same time benefiting the company through an increased demand for its fertilizer products. 2) The Nestle Company is working to improve milk production in certain regions of India, by investing in well drilling, refrigeration, veterinary medicine, and training, thereby significantly increasing output and enhancing product quality, certainly beneficial to the company, and at the same time allowing the company to pay higher prices for farmers and their employees, resulting in a higher standard of living for the local community.

The United Nations now has a business initiative on corporate social responsibility, called the United Nations Global Compact under which companies voluntarily agree to make improvements in human rights, labor, the environment, and combating corruption. The World Bank has an Internet course on social responsibility, called "CSR and Sustainable Competitiveness," offered by its educational and training division and designed for "high-level" private sector managers, government officials and regulators, practitioners, academics, and journalists. One major purpose of the course is to provide a conceptual framework for improving the business environment to support corporate governance policies and social responsibility efforts by corporations and business. The course is also designed to assist companies to formulate a social responsibility strategy based on moral and economic values as well as one with a long-term perspective.

This attention to CSR is reflected in the moves by governments and quasi-governments to embed it in expectations for companies. France in

2001 was the first country to require systematic disclosures of the social and environmental performance of major corporations; and England now also requires disclosures by corporations of their social performance. In 2000 the European Council in Lisbon formally encouraged companies to become more socially responsible, for example, by taking into consideration sustainable development. In 2006 the European Commission enacted a Resolution, titled “Corporation Social Responsibility: A New Partnership, which declared that corporate social responsibility now has become an increasingly important subject matter for the European Community and that corporate social responsibility is an essential component of the debate about globalization and sustainability (Mickels, 2009). In 2009 the Indian government, specifically the Ministry of Corporate Affairs (MCA), mandated that public-sector oil companies spend 2% of their net profits on corporate social responsibility efforts. This was followed one year later with a requirement that Indian companies have a CRS policy which “targets” a 2% spending allocation on CSR; and that companies provide disclosure and details of their CSR efforts and suitable reasons for these efforts (or the lack thereof) in an annual report (Afsharipour, 2011). Further proposals are to the effect that the government should mandate that private sector companies spend 2% to 5% of their net profits on corporate social responsibility efforts. However,

Of course, there is a big difference between India and a country such as the United States. In the U.S., pursuant to corporate constituency statutes, a company may be socially responsible and also may impose a legal obligation upon itself to be socially responsible by forming a social benefit corporation; but neither the federal government nor the state governments in the U.S. presently are mandating legally that companies be socially responsible ones (although the so-called corporate constituency statutes (discussed further in the next section) of such states as Connecticut: CONN. GEN. STAT s.33-313 (2003); Arizona: ARIZ. REV. STAT s.10-1202 (2002); Idaho: IDAHO CODE s.30-1602 (2002) permit or mandate stakeholder consideration in corporate decisionmaking).

III. Stakeholder Values

Stakeholder theory was first developed over 40 years ago by Klaus Schwab, the founder and chairman of the World Economic Forum, based in Geneva, Switzerland. Schwab explained that “stakeholder theory... considers the enterprise as a community with a number of stakeholders – in other words, social groups that are directly and indirectly connected

to the enterprise and that are dependent on its success and prosperity. These groups include employees, customers, suppliers, the state and especially the society's in which the enterprise is active" (Schwab, 2010, p. A19). In order to illustrate the stakeholders and their values involved in business decision-making, as well as to show the relationship among stakeholder values, social responsibility, and sustainability, the authors have prepared the following Table, which was based in part on the work of Professor N. Harish (Harish, May, 2012, p. 522):

**Table 1 – STAKEHOLDER VALUES,
SOCIAL RESPONSIBILITY AND SUSTAINABILITY**

Stakeholders	Primary Values	Secondary Values
Owners/Shareholders	Financial Returns and Income	Growth and Added Value
Employees	Jobs and Pay	Job Stability and Satisfaction
Customers and Consumers	Supply of Goods and Services	Quality, Price, and Customer Service
Suppliers/Distributors	Contract Relationships and Payment	Long-term Relationships
Creditors	Payment and Rate of Return	Credit-worthiness and Security
Community	Employment and Tax-base	Philanthropy and Social Responsibility
Government	Legal Compliance and Tax-base	Competitiveness and Entrepreneurship
Competition	Market Share	Legal and Ethical Competition
Society	Growth, Prosperity, Sustainability	Social Responsibility and Environmental Stewardship and Improvement

Table 1 shows the typical stakeholders in the business realm, that is, those constituent groups which are directly or indirectly affected by corporate actions. The Table then shows what these stakeholders value, that is, what they deem to possess worth - primarily and secondarily. These stakeholder groups typically are the following: shareholders and owners, employees, customers and consumers, suppliers and distributors, creditors, community, government, competition, and society. Shareholders as the owners are always listed first. Obviously, a corporation cannot survive unless it serves and benefits its shareholders in a financial sense. However, today, shareholders may view their investment as one that benefits society too and perhaps in a direct manner by means of the social benefit corporation.

Regardless, all shareholders are entitled to the honest and efficient management of their investment as well as a fair return on their investment.

Employees are of course interested in obtaining and maintaining employment. They value a just wage, fair employment practices and working conditions, and job security. They also may value working for a company that is regarded as “socially responsible”. Customers and consumers want access to goods and services that are of good quality, at a fair price, and that come with good customer service. Suppliers and distributors want financially rewarding, long-term contractual relationships with the company. Local communities want to see the corporation located in their cities and towns so as to provide employment for the citizens and residents and to support the local tax-base. The local community also values, and may very well expect, that the corporations in its vicinity participate in civic, charitable, philanthropic, and socially responsible activities. Creditors expect a fair rate of return as well as adequate assurances of security for the obligation. Government values business for legal compliance with business laws and business regulations and as an important component of its tax-base. It also values and thus desires to promote entrepreneurship and competition. The competition values its own market share, expects “tough” and “hard-hitting” competition, but that which is legal and ethical. Society values its survival, growth, prosperity and the sustainability of business and society. Today too, society values, that the corporation will be socially responsible, particularly in relation to the environment.

Therefore, the goal of the business leader today is to balance and harmonize these values. Such an achievement requires corporate governance policies that maximize these values in a legal, moral, socially responsible, and practically efficacious manner, thereby resulting in “win-win” scenarios for the business and all its stakeholders and attaining a level of continual sustainable business success.

IV. Corporate Constituency Statutes

Socially responsible entrepreneurs and corporate directors and officers who wanted to engage in activities to benefit corporate stakeholders other than shareholders have in the past confronted a serious legal problem. Traditionally, pursuant to state corporation law, the directors and officers of a corporation owed legal and fiduciary duties solely to the corporate entity. This overarching duty of the traditional corpus of corporate law is to maximize shareholder wealth.

In fulfilling this duty, the directors and officers, based on the conventional Business Judgment Rule of corporate law, were required to act based on informed consent, with reasonable care, and in good faith. These legal duties were owed strictly and exclusively to the corporation and to the shareholders and not to any other people or groups, though the shareholders might have to enforce these duties on behalf of the corporation, if a breach of these duties by the directors and officers occurred, by means of a shareholder derivative lawsuit.

Today, however, as mentioned previously, many states have enacted statutes, called “constituency statutes,” or have amended their corporation statutes, to allow the directors and officers to consider other constituent groups, often called “stakeholders,” who are directly or indirectly affected by the corporation’s activities. As of 2003, in the United States, forty-one states had enacted “constituency statutes” that authorize management to take into consideration a range of stakeholder interests in addition to the interests of the shareholders. Pennsylvania passed the first constituency statute in 1983. The District of Columbia has promulgated such a statute too. These constituency statutes effectively expanded the autonomy and importance of the board of directors, particularly in fulfilling their corporate governance functions. Even though some states, such as Delaware, do not have express constituency statutes, nevertheless, the courts have ruled that pursuant to state corporation law the directors of a corporation can consider the effects of corporate actions on non-shareholder groups, such as customers, employees, and the general community. It also should be mentioned that Delaware is the state of incorporation for almost 2/3rds of publicly traded companies in the United States.

There is some variety among the provisions in the state statutes in the United States; but most statutes limit the consideration of stakeholder interests to those of customers, employees, creditors and the local communities. These permissible constituency groups typically include employees, creditors, suppliers, consumers, and the community at-

large. However, the scope is limited by the fact that the definition does not encompass the international community, environmental concerns, or broader human rights issues. By virtue of the Companies Act of 2006 (UK) s72, the directors of British companies are allowed to take into consideration the long-term interests of the corporation, which includes the effect of corporate actions on employees, customers, suppliers, the community, and the environment.

It is critical to note, however, as mentioned above, constituency statutes are generally permissive, not mandatory; that is, the directors and officers may but are not required to take into consideration the interests of non-shareholder stakeholders, thereby enabling them to justify and to possibly defend a decision that they believe to be in the best interest of the corporation without contravening the duties owed to shareholders. However, the directors are still required to make these decisions with the aim of maximizing the long-term good, not of the public, but ultimately of the shareholders. . Significantly, too, these statutes only permit a balancing of interests rather than requiring a balance. These constituency statutes, therefore, do not impose any legal duty on the directors to any stakeholders or constituencies and do not furnish such interests with any legal cause of action against the corporation's directors.

V. Social Benefit Corporations

In marked contrast to the corporate constituency statutes, as well as the traditional corporation itself, is a new legal business concept – the “social benefit corporation.” These new entities also are called “benefit corporations,” or simply “B-corporations” (as opposed to the traditional business or “C-corporation”). At times, the general term “social enterprise” is used to describe a social benefit corporation. Very recently in the United States, this new form of business enterprise has been created to provide a corporate legal structure for “social entrepreneurs,” that is, those business people who aim to deliver not only financial benefits to the shareholders but also social benefits for other stakeholders, including local communities and society at large by means of a “double bottom-line” of profits and social benefits or a “triple bottom-line” of social, environmental, and economic concerns. Social entrepreneurs firmly believe that social good can be produced along with profits, and thus they desire hybrid forms of business organizations to effectuate the achievement of both goals.

The concepts of social business and social entrepreneurship were first conceived by Mohammad Yunus, the founder of Grameen Bank, and the

winner of the 2006 Nobel Peace Prize, for his pioneering work in micro-credit. Yunus believed a social business must be not only a viable business enterprise but also one created and managed for the express purpose to pursue and achieve specific, articulated, social goals, rather than “merely” maximizing profit

The critical difference between a social benefit corporation and a constituency statute in the U.S. is that in a corporation constituency statute the directors of a corporation may consider other stakeholder groups, but with a social benefit corporation, the directors must consider them. In a social benefit corporation, typically in the company’s articles of incorporation (which becomes its charter when approved by the state), the corporation will specify its intended social purposes or benefits as well as the stakeholders or constituent groups that it is legally obligated to consider in achieving these objectives. Hence it is a legal duty for corporate directors to consider the consequences of corporate actions, such as moving facilities from one state to another or overseas, lay-offs and downsizing, and takeovers and mergers, on groups other than the shareholders. Moreover, the directors are allowed to consider social responsibility and environmental objectives equal to or even greater than achieving profits.

For the law in the form of a social benefit corporation to now say that directors have a legal duty, that is, must, as opposed to may, consider the interests of other stakeholders affected by corporate activities is a very momentous change in the law indeed. It must be emphasized that consideration of the other constituencies beyond the shareholders is mandatory.

Several states in the United States, including Vermont, Hawaii, California, New York, New Jersey, Virginia, North Carolina, Pennsylvania, and Maryland (the first in 2010), , have now promulgated legislation to allow “social benefit” corporations. As of the writing of this chapter, legislation has also been introduced in Colorado, Michigan, Pennsylvania, North Carolina, and Oregon. The states generally have based their social benefit corporation statutes on a “model” act, called the “Model B-Corp Act.” Pursuant to the Model Act as well as the state corporation benefit statutes, typically, the social benefit corporation must be cleared designated as a benefit corporation, and must specify in its social responsibility and environmental objectives in its charter and articles of incorporation, and also in some cases in its bylaws. In Maryland and other states the stock certificates also must be labeled to include the term “benefit corporation.” The benefit corporation differs somewhat from an NPO and can pursue a

“general public benefit” and/or “specific public benefits,” such as providing low income or underserved people or communities with beneficial products or services, promoting economic opportunity for people and communities, preserving, protecting, and improving the environment, improving human health, promoting the arts and sciences, advancing knowledge, and increasing the flow of capital to entities with a public benefit purpose. The social benefit corporation statutes require the directors of the corporation to consider the impact of their decision-making not “merely” on the shareholders, but also other corporate stakeholders, such as the employees of the corporation, subsidiaries, suppliers, distributors, customers, the local community, society, and the environment, whether local or global. The social benefit report corporation also must publish an annual “benefit report” to disclose the level of performance in attaining those goals as well as any circumstances the corporation’s ability to achieve its beneficial purposes. The report must be delivered to shareholders, posted on the company’s website, and, in some case, delivered to the state’s Secretary of State (who is typically the state cabinet level official who typically is in charge of corporate affairs).

The statutes under which such corporations are enabled, specify that independent third parties will assess the performance of the corporation. However, the statutes are lacking in specifics as to how this is to be achieved. They do not provide even minimum content for such beneficial standards, nor do they indicate how the standards should be applied, when and how often, and by whom. Further the statutes do not require a benefit corporation to use any particular third-party standard, explain why the corporation chose a particular standard, nor have their benefit report certified or audited by a third party. Typically, the social benefit corporation posts its annual report, a self-assessment, and the third party evaluator’s report and summary on the B-Corp’s website. It characteristically has a benefits officer who has the responsibility of assessing the company’s charitable contributions and socially responsible activities and who reports them to the third party evaluator. No report, however, usually is required to any government agency.

Other countries have comparable forms of social benefit corporations. For example, the Community Interest Company (CIC), available in the United Kingdom since 2005, is designed to meet the needs of social entrepreneurs in the United Kingdom. Comparable to the U.S. “B-Corp,” the CIC is formed for “community benefit” purposes. The two key components of the CIC are the “community interest test” and the “asset lock”: “The community

interest test is relatively broad. ‘A company satisfies the community interest test if a reasonable person might consider that its activities are being carried out for the benefit of the community.’ Political campaigning, however, is excluded. The organization also must not limit access to its benefits to too small a group.... ‘Asset lock’ is the term used for all provisions that endure the CIC’s assets and profits are used primarily for the benefit of the community and not for the excessive benefit of employees, contractors, or investors....Investors may buy shares, but dividends are capped, both at a specific rate of return and as a percentage of profits that can be paid in aggregate dividends” (Page and Katz, 2011, pp. 1370-1371; Reiser, 2011). The CIC must issue a “community interest company report” together with its annual financial filing and is regulated by a government regulator, who can intervene if the CIC no longer meets the community interest test.

One very serious caution for those exploring the option of a social benefit corporation is that the law is still developing for this new form of doing business particularly as to the scope of the expanded legal duties of the directors, particularly whether the social benefit duties are separate and distinct from traditional corporate duties, as well as to what the relationship is between the two sets of duties. . Consequently the major risk is the still un-chartered legal liability of the directors, who possibly may be sued by shareholders for not achieving social responsibility goals and who may be sued by other stakeholders who are adversely affected by a corporation action which they contend is socially irresponsible to a discrete stakeholder group or injurious to the societal good. This new legal cause of action against directors in the U.S. typically is called a “benefit enforcement proceeding.” It is quite possible that in the U.S., shareholders, directors, employees, and any other persons or groups specified in the articles of incorporation of the benefit corporation might bring an action against it for failure to pursue the general public benefit or any specific public benefit set forth in its articles of incorporation.

One point is evident, though, and that is shareholder primacy does not apply. Consequently, a paradoxical situation could arise because the directors of B-corporations would be legally required to disregard the traditional notion of shareholder primacy and thus take other stakeholder values and interests into account, but they would not be legally entitled to completely ignore shareholder interests. To further complicate matters, some of the state statutes also fail to address the key issue as to what non-shareholder stakeholder groups have legal standing to sue to enforce the expanded legal duties of the directors. Now, too, the shareholders of

a social benefit corporation may have expanded rights to bring derivative lawsuits (that is, suits pursuant to traditional corporate law against the directors on behalf of the corporation when the directors fail to act) on behalf of other stakeholders. The social benefit corporate way of doing business in the United States is thus today a vague one, and also one that engenders conflict between pursuing desirable social objectives and striving to maximum profits. As such, there will be inescapable legal conflicts as the courts attempt to define and to reconcile the principles of the legal and fiduciary duty in the context of corporate directors seeking to achieve business objectives and also to fulfill social obligations. So, based on the current state of the law and the legal commentary examined for this chapter, the logical conclusion from the authors' perspective is that the new way of doing business in the U.S. as a social benefit corporation, though well-intended, should be abjured, at least for the present, until the attendant legal rights and responsibilities can be explicated by the courts. Yet social responsibility pursuant to corporate constituency statutes can be a viable legal activity for a company as well as a smart, sustainable, and socially beneficial one.

VI. Low-Profit Limited Liability Companies

Another very recent innovation in social business entrepreneurship is the low-profit limited liability company, called an L3C, which is a “social” variant of the ordinary limited liability company (LLC). The L3C, though organized as a traditional LLC, is expressly designated as a low-profit entity with explicit charitable or educational objectives. An L3C must pursue a charitable mission, but it also can distribute profits to its investors. However, making profits, growing via accumulation of property and relying for returns on appreciation in the value of assets cannot be the primary purpose(s) of the entity (Page and Katz, 2011). Vermont was the first state to enable the creation of L3Cs and now seven other states, including Montana and Wyoming, also allow them. In essence, L3Cs were created to accommodate for-profit entrepreneurs who desire primarily charitable purposes but who also want to attract philanthropic investors and investments from charitable foundations. However, the major problem with the L3C is that it is not certain that investments in L3Cs will qualify as charitable investments pursuant to federal tax law in the United States. So, prudence would suggest that the usefulness of L3Cs remains in doubt, because the efficacy of the L3C form of doing “business” in the United States depends on the willingness of the Internal Revenue Service to support the form.

VII. Social Responsibility, Stakeholders, and Corporate Governance

Corporate governance today has emerged as significant subject for business; and the topic of social responsibility arises in the context of corporate governance. As a reminder, in the traditional governance models, the corporation's primary focus is on shareholder rights, and the primary governance rule is based on maximizing shareholder value. Directors, therefore, have a duty to ensure that companies fulfill their legal obligations, protect shareholder interests, and provide accurate and timely information to investors, markets, and government regulators. Yet corporate governance also has social and ethical ramifications. Overall, then, corporate governance embraces the whole gamut of legal, ethical/moral, and social responsibility considerations for regulating business today. Business decision-making cannot be decoupled from the responsibility – legal, ethical, and social - of business leaders for their own risk-taking; otherwise, the whole business and entrepreneurial system will be undermined.

Making profits in a legal manner is obviously an essential component to corporate governance; but the focus on “just” the law is too narrow, a position reflected in the Principles of Corporate Governance (American Law Institute, 1994). The primary principle is for the corporation to conduct the business with an objective of enhancing corporate profit and shareholder gain. However, the corporation may take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and also the corporation may devote a reasonable amount of resources to charitable, philanthropic, humanitarian, and educational purposes; and the corporation may do so in both situations even if shareholder profit and shareholder gain are not thereby enhanced (American Law Institute, 1994).

So, although the primary focus is on the monetary value, this objective is moderated by ethical and social responsibility values. The idea is that the corporation will engage in self-governance; and thus regulate, not only by the strictures of the law, but also by morality and ethics, as well as stakeholder and societal concerns, the manner by which it generates profits. However, this can only be realized if those who exercise control whether directly or indirectly have the vision to see that the collective future of the business, its stakeholders, and society as a whole is inextricably tied to the sustainability of the entity and the society in which it operates and flourishes, as well as the strength of character and leadership ability to implement and act on that vision. The question is this: given the law, tradition and expectations applying to the different types of corporation, how can such be achieved?

In the C Corporation former Vice-President Al Gore emphasizes a sustainable form of capitalism; and accordingly provides some suggestions on how to structure corporate governance to maximize long-term shareholder, stakeholder, and societal value creation. Specifically, Vice-President Gore wants to empower and motivate business leaders to manage for the long-term by using incentive and compensation systems:

To begin with, compensation should be aligned with long-term objectives, and financial rewards should be linked to the period over which results are realized. For example, in the asset management industry, we are strong proponents of multiyear rolling performance fees in order to incent investors to manage assets with a long-term perspective....Incentive structures should also reflect more complete measure of performance, for example, increasingly, best practice companies are explicitly including environmental sustainability, customer satisfaction, employee morale and workplace safety in their incentive schemes. These companies understand that these considerations drive long-term financial performance (Gore and Blood, 2010, p. A21).

Business leaders, therefore, must exert – leadership – to improve incentive and compensation systems as well as other aspects of corporate governance to enhance sustainability.

Corporate governance guidelines for social responsibility should be premised on fundamental principles. First the company should formulate a corporate social responsibility policy to guide its strategic planning and provide a roadmap for its CSR initiatives. Second, that policy should be an integral part of the organization's overall business policy and aligned with the company's business goals. Third, the policy should be created and framed with the participation of various level executives as well as representatives of other stakeholder groups, and the policy must be approved and overseen by the board and implemented by top management. The corporate social responsibility policy should cover the following core elements: (1) adherence to the law; (2) acting in an ethical, honest, and transparent way; (3) consideration of the values and interests of all stakeholders, including shareholders, employees, customers, suppliers, local communities, society at large, and the environment; (4) treating all stakeholders with dignity and respect and as worthwhile means and not as mere means; (5) charitable and philanthropic activities; and (6) activities that promote social and economic development.

A socially responsible firm, however, must also be a realistic one; that is, socially responsible stakeholder considerations, and environmental efforts must be sustainable economically and should have some relationship to the firm's business. These prudential considerations should be reflected in the company's corporate governance policies. Employees, for example, should also be engaged directly in the company's social responsibility activities so as to engage them, inspire them, motivate them, and thereby enhance morale and productivity. Moreover, a firm's social responsibility program does not have to be a multi-million dollar effort; rather, something as simple as an employee social responsibility "suggestion box," or as straightforward as a recycling or energy saving program, will do to promote employee involvement as well as to promote and give credence to employee social values. Nonetheless, despite the size, a firm's social responsibility efforts should be publicized widely within the company (for example in company newsletters), as well as externally (in company annual "social responsibility" reports and on its website). Being socially responsible, is a smart and sustainable business strategy: the company's corporate governance policies must be tailored to promote it.

While social betterment is a driving ethos for B corporations, this does not imply the issues around governance for social responsibility are solved. Rather, corporate governance emerges as a particularly challenging endeavor given the dual mission of profit-making and societal betterment, the concomitant trade-offs among competing stakeholders (including shareholders) the ensuing competition for corporate resources, the lack of a specific B-Corp government regulator, and the absence in the state legislation as to how the conflicting stakeholder demands should be balanced. Although management of the social benefit company can refer to the standards set forth by the third party evaluator to whom the B-Corp must report, since the social benefit corporation legislation provides no concrete guidance, there is an assumption that the top management team will weigh the company's social responsibility goals in light of their business objectives, and then arrive some reasonable determination that advances profit and all stakeholder values (which means that the third party standard can provide no more than guidance). Moreover, it is important that the views of top management team be balanced within the company via mechanisms that allow for stakeholder representation, invite stakeholder participation, and keep internal channels of communication open and flowing. At the very least, due

to the mixed mission, vague corporate socially responsible standards, conflicting stakeholder demands, as well as citizen and interest group pressure, the activities of the corporation will be, and should be, carefully monitored – principally by its management as part of their governance function, but also by company stakeholders, government legislators and regulators, and concerned citizens.

VIII. Implications and Recommendations for Business Leaders

The new corporation structure of the social benefit corporation is a clearly meritorious way of doing business. Yet at this time it also is plainly a problematic one for business people, directors, and entrepreneurs, even very socially responsible ones. The law is just too new and unsettled as to nature of the public benefit and especially as to the legal risks of being a director of a “B-corp.” As such, no corporate board of directors wants to be the “test case” in determining the parameters of legal liability under this model. Similarly, with the very new L3C way of doing business socially until the IRS promulgates some precise rules, this entity, again, though similarly laudatory, is to be avoided.

Nonetheless, socially responsible people who plan to incorporate can always include social responsibility goals in the articles and bylaws and corporate governance policies of a traditional corporation; and the typical state’s constituency statute expressly allows the consideration of other stakeholder groups. So, the legal latitude exists to be socially responsible, yet without mandating a legal duty on the board. Moreover it is in the long-term, egoistic, self-interest of the corporation to be a socially responsible one and thus to be active and engaged in community, civic, and charitable activities.

Yet what exactly is the effect of all these social responsibility efforts on the “bottom-line”? This critical fact is difficult to ascertain due to the need for more research as well as the need for a longer-term perspective. One academic study, conducted by Schnietz and Epstein (2005), found that there is value to a corporation during a crisis from having a reputation for corporation social responsibility; in particular such a reputation protects firms from a decline in share prices. Sausser, Jr. (2008) points to studies that found direct financial benefits for companies who are deemed to be socially responsible; and these benefits encompass enhanced business reputation, consumer acceptance, employee loyalty, as well as better environmental management. Hemlock (2007) reported on an academic analysis of dozens of corporate social responsibility studies that found that

social responsibility performance and financial performance reinforce each other; that is, companies that excel in a socially responsible manner generally excel financially and vice versa (although one could argue with this aspect of his findings).

The aforementioned illustrations and studies demonstrate that social responsibility “pays off” for the company and its shareholders as well as for other stakeholders and society as a whole. The problem of determining if “doing good” translates to “doing well” is exacerbated since companies only report the value of tangible physical assets and investments in equipment and property. Social responsibility efforts are perhaps too intangible for the company’s accountants to quantify; and government regulators do not mandate that social responsibility, labor, and environmental practices be quantified. However, a company’s commitment to social responsibility could constitute a valuable intangible business asset; and innovative business leaders could view these social responsibility challenges as growth opportunities.

Another problem confronting corporate social responsibility, especially in the “constituency” or “sustainability” sense, is resistance from shareholders, who may be more interested in short-term profits than long-term sustainable profits. Today’s shareholders may prefer immediate maximization of share value over a more long-term approach that is willing to wait for potentially greater returns in the future. This preference may lead management to prioritize short-term profits over longer-term considerations. This narrow approach will discourage corporate social responsibility and stakeholder analysis because benefits to stakeholders other than shareholders will reduce short-term profits. Nonetheless, it is the job of the business leader to educate the shareholders, and perhaps corporate management as well, of the benefits that will accrue to the company and the shareholders by the company acting in a smart, shrewd, and strategic socially responsible manner. Corporate social responsibility, as such, should be treated as an investment, not a cost, comparable to quality improvement and employee training. Business leaders, executives, and managers, therefore, must be cognizant of and appreciate the instrumental strategic value of social responsibility in its constituency and sustainability formulations. Business leaders, executives, and managers today surely are well aware of societal expectations regarding the social responsibility of their companies.

Figure 1 – THE BUSINESS SUSTAINABILITY CONTINUUM



The term “sustainability” also has emerged, along with social responsibility and corporate governance, as important subject matters for business today. A sustainable business is one that is governs itself in a long-term, stakeholder centered, and environmentally conscious manner. The term, “The Triple Bottom Line,” representing people, planet, and profits, which was created by John Elkington in 1994, also is directly related to sustainability. The concept means that to be a sustainable one, the business must be concerned not “merely” with profits, but also must pay attention to and seek to balance, stakeholder interests and environmental concerns. According to Elkington, the three dimensions of sustainability under the “Triple P” formulation are economic prosperity, environmental quality, and social justice and equity. Sustainability, therefore, has legal and ethical components, and as such will result in moral (ethics-based) decision-making by companies. In order to better illustrate as well as explicate the values of practicality, legality, morality, social responsibility, and stakeholder interests, and their relationship to sustainability, the authors have developed the model presented in Figure 1 (Mujtaba and Cavico, 2013), called The Business Sustainability Continuum (BSC).

The BSC illustrates that the continual success and “sustainability” of the business can only be achieved by an adherence to four core values (Mujtaba, Cavico and Plangmarn, 2012): Economic, indicating that a business obviously must have a viable business model which fulfills a need and enables the business to make a profit; Legal, indicating that this profit must be achieved in legal manner by aligning the conduct of the business with all applicable local, national, and international law; Ethical, indicating that since there may be no law or “gaps” in the law nonetheless

the business must act in a moral manner and also must act in conformity with its values, promises, and obligations; and Social Responsibility, indicating that the business must focus on the community and engage in civic, philanthropic, and charitable endeavors as part of the business' overall strategic plan. Sustainability will help the business; but also help the business help governments solve pressing social problems; and, as such, sustainability provides a means to rebuild trust in the economic and political systems, which naturally is good for business and good for society. Accordingly, corporate governance policies must be devised to give credence and implementation to these "sustainable" values; and thereby will enable the business to achieve success and to sustain that success in a continual manner, thus benefiting the business, its shareholders, communities where it does business, and (ideally) all the stakeholders affected by the business, including society as a whole.

IX. Summary

One can argue philosophically whether values are intrinsically "real"; yet it would seem reasonable to argue that values such as social responsibility, sustainability legality, ethics and morality are not only essential aspects of business but also possess instrumental worth as they increasingly drive consumer and employee loyalty. . Business leaders must be cognizant of these values when envisaging the corporate vision, mission, and agenda. . Furthermore, the emphasis on stakeholders or constituency groups is an essential component of business leadership and corporate governance. The business leader must take an enlightened approach to satisfying the values of stakeholders in order to achieve long-term sustainable success. As emphasized, the ultimate goal is to attain "win-win" resolutions where all the company's stakeholders receive value. Social responsibility emerges as a key element in achieving stakeholder symmetry, financial success and business sustainability.

Admittedly, in certain cases, social responsibility concerns may be more difficult for business people, who are primarily focused on economic issues, to discern and to handle. Moreover, there may be problems reconciling the conflicting demands of various constituencies. Nonetheless, business leaders in fulfilling their corporate governance function are expected to recognize competing stakeholder interests and devise practical, legal, ethical, socially responsible, and mutually beneficial solutions. They may have to convince certain stakeholders, such as the shareholders, that it is in their long-term self-interest to accept some short-term financial

sacrifice, say in the form of company socially responsible efforts in the local community, in order to produce longer-term greater financial gains and assure the future for the enterprise. .

Social responsibility, therefore, is more than just “mere” “pure” charity; rather, in modern business sense social responsibility is an integral strategic component in a company’s endeavor to achieve larger “pure” business objectives; and concomitantly, and also propitiously, society as whole is benefitted too by these social responsibility activities. Business, therefore, needs a formal, coherent, transparent, strategic, stakeholder-based, and sustainable policy to social responsibility. The goal is to make a positive, beneficial, and sustainable contribution to the company’s growth, economic growth, societal growth, and the betterment of the environment. So, corporate social responsibility and sustainability are “smart business” and “good business” – for business and society. The old maxim is true: one can do well by doing “good”!

A salutary lesson can be taken from the recent real estate/mortgage/banking crisis in the United States, resulting in the still recessionary U.S. as well as global economy, was in main part created by so-called business “leaders” abandoning common sense, good sense, and ethics, as well as abdicating their corporate governance obligations and acting in a short-term, solely profit-centered, immoral, if not downright illegal, manner. Instead of earning rewards fairly, the prevailing mentality was a “get-rich-quick” one exacerbated by the false belief that price of real estate would go up – forever! Consequently, people with “NINJA” loans, that is, with no jobs, assets, or income, were borrowing money that they realistically could never repay to buy over-valued houses. Then the so-called, though accurately called, “sub-prime” mortgages, guaranteed in main part by the U.S. government, were “securitized” into basically fraudulent securities, though securities rated as “safe” ones. Next, these essentially worthless “paper” securities in the form of sub-prime, over-rated mortgages were sold to many, many unsuspecting buyers, all the way to Iceland. This series of events resulted in a financial disaster and economic “meltdown.” Individualistic, risky, short-term, profit seeking – from real estate agents, mortgage brokers, and bankers - was the “moral” norm; and the deleterious effect on society of this misbehaviour did not even register. The result was a massive destruction of value – short- and long-term – the ruination of businesses, business and personal assets, and people’s lives, necessitating massive taxpayer “bailouts,” and engendering a serious undermining of confidence in economic and political systems.

Capitalism and free markets are built on, as Adam Smith wisely stated long ago, a foundation of morality. The economy needs to be free to function, but the economy also needs rules to function correctly and effectively. And when the legal rules are not present or they are not clear, there is all the more need for ethics and socially responsible behaviour. The idea is to create a sustainable form of capitalism, whereby acting in a legal, ethical, and socially responsible manner, as well as taking a long-term perspective, will produce profits for the shareholders but long-term value for all the other stakeholders of the company. The task of business leaders, therefore, is to incorporate not only legal rules but also ethical, social responsibility, and stakeholder considerations into corporate values, mission statements, governance policy, and strategy, and to do so not “just” nationally but globally. Transparency, truthfulness, and trustworthiness have been, are, should be, and must be the hallmarks of successful business; business managers have a moral obligation to be trustees of all the stakeholders of the organization; yet, sadly, these moral lessons now must be learned once again. A true business leader must be keenly aware and engaged, must look ahead, and must foresee the consequences of his or her company’s actions on all the firm’s stakeholders, including society as a whole. Business leaders must be aware that law, ethics, and social responsibility are all interconnected and underpin the economy and the free market system. The authors hope that their chapter to this book supplies a reminder, a rationale, and a guide for legal, ethical, and socially responsible behaviour, as well as a warning of the “fruits from the poisonous tree”; and thus the authors hope that their contribution to this book serves as a tool for true business success, stakeholder responsibility, and organizational and societal sustainability. Capitalism, yes; but a capitalism “regulated” and tempered by law, ethics, morality, and social responsibility, and thus a capitalism with a “communitarian spirit” or, in the words of the Venetians long-ago (yet still quite true), a “communally controlled” capitalism.

Discussion Questions

1. One cannot be sued for acting in a socially irresponsible manner (unless some other law is contravened). So, why should one, or one's business, be socially responsible?
2. The conservative economist and Nobel prize winner, Milton Friedman, said in a famous essay that the "social responsibility of business is to make money," legally, of course, and pay taxes, and not to be concerned with charitable or philanthropic endeavors. Do you agree with Friedman? Why or why not?
3. For the socially responsible entrepreneur, what are some of the advantages and disadvantages of incorporating the business in a state in the United States that has the social benefit corporation as a way of doing business? What about the socially responsible investor?
4. What do the terms "social responsibility," stakeholder analysis, "sustainability" and "people, planet, profits" mean to you in a modern global business environment? Provide examples.
5. Corporate social responsibility (CSR) is viewed by some as a positive phenomenon since CSR helps to "bridge the gap" of social inequality in the world and thus helps to contribute to sustainable development. What organization or company exemplifies this level of CSR in the modern era? Why?
6. Why would anyone invest in a company, such as a social benefit corporation, when the economic returns are very likely to be diminished by the benefit objectives when certainly other investment opportunities exist offering the likelihood of greater returns?
7. When conflicts arise between shareholders, employees, consumers, and the general public, to whom does the corporation owe allegiance? Why?
8. What is "strategic social responsibility" and how can it be used to benefit the organization in the long-run?
9. If it is determined that a corporate culture is deemed to be a socially responsible one in nature, how can one change this culture to encourage socially responsible behaviour? And why should it?

10. What corporate governance policies would you suggest to promote consideration of stakeholder interests beyond the interests of the shareholders? Why?
11. Should socially responsible behaviour by business be mandated by government, such as in the case to some degree in India, or will the self-interest of business promote socially responsible conduct?
12. What does “sustainability” mean to you in the context of business? What actions should a business take to be a “sustainable” one?
13. What is an example of a national or international company or organization that is considered to be “sustainable” because their leaders adhere to economic, legal, ethical, and social responsibility values in the modern workplace? Explain how these leaders govern the company or organization to implement these values.
14. The Venetians through history fervently believed in, and prospered by, international business, trade, and finance; but they called the economic system of the Venetian Republic “communally controlled capitalism.” What does that term mean to you, and does it have any relevance to modern day business?

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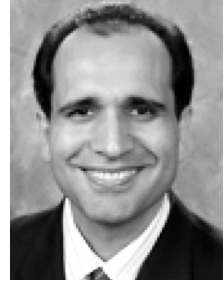
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Chapter 4

What's Wrong With CSR (or Stakeholder Theory)

Tibor R. Machan

Abstract

The academic business ethics community is nearly universally committed to a stakeholder theory of corporate management or to the idea of corporate social responsibility (CSR). I want to criticize this stance and show that it is misguided and violates some basic principles, including the individual investor's and shareholder's right to choose the way he or she will use his or her resources.

Of course, there are some complications. Some stakeholder theorists argue that aside from pursuing the company's economic objective to prosper, the company ought also to devote some resources to advancing various benevolent goals, such as helping community organizations, contributing to medical research, aiding needy persons, etc., but all on a voluntary basis. This version of the position is not the target of my criticism.

There are those, however, who champion a version of stakeholder theory or CSR whereby pursuing various goals other than the company's prosperity are supposed to be a priority and mandatory, to be legally enforced. It is this latter stance that will be the target of my criticism.

I will argue that ordering or legally mandating that companies promote the welfare of stakeholders is a violation of the right to freedom of choice, the right to private property, and the right of sovereignty. However benevolent it may appear to promote the stakeholder or CSR stance, it is coercive and has no place in a free society.

Introduction: Altruism and Business Ethics

The concept of "business ethics" is often dubbed an oxymoron and, given the popularity of altruism – indeed, given how so many equate that school of ethics and ethics itself – this is quite natural. Altruism is difficult to reconcile with business because the aim of the latter is prosperity. Owners hire managers so the latter will produce a good return on the investments

of the former. Be it big or small, managers of firms aim to increase the value of the enterprise, to make the owners flourish economically.

Although this need not be characterized as selfishness – something some economists have mistakenly promoted – neither can it be considered unselfishness. The reason seeking to prosper need by no means amount to selfishness is that the ultimate goal to be served by the economic value created in the running of a business could well be quite varied and even unselfish. For example, often someone like Andrew Carnegie, Warren Buffet or Bill Gates actually earn their wealth in some measure so as to then be able to help other people, even those in foreign lands (as the Bill and Melinda Gates Foundation is devoted to helping Africans). Those in business are not only in business; they are also family members, friends, citizens, etc., etc. Even in the more routine cases of running a business, often owners and investors spend a portion of their earned wealth on projects they find worthwhile (the arts, scientific research, various philanthropies, etc.), instead of strictly on themselves. (It is prejudicial to see people in business as somehow incapable of such humanity!)

What is difficult to dispute, however, is that those for whose economic benefit businesses are managed would normally to decide to whom the wealth being produced is going to be distributed, how it will be allocated. So, arguably, what wealth-production enhances most is, if not self-interest, then certainly choice – the ability of owners to decide what and whom to help out (which can, of course, but need by no means include only oneself).

How, then, does altruism impact business management? Where does it even make its appearance in business ethics, if anywhere at all? As noted, in commerce and business people at the minimum promote their own ability to have an impact on the world by enriching themselves. Often they do aim, of course, to improve upon their own economic well being. So if altruism is right, it would appear that commerce and the profession of business face an uphill fight in any effort to gain moral standing.

But is altruism right? Should we live for others?

Altruism and CSR (corporate social responsibility)

Altruism, as one philosopher has defined it, “[is] assuming a duty to relieve the distress and promote the happiness of our fellows....Altruism is to ... maintain quite simply that a man may and should discount altogether his own pleasure or happiness as such when he is deciding what course of action to pursue.”[i] This ethical stance makes its appearance in business ethics most directly via the theory of stakeholder corporate management,

one that stresses the primary of the social responsibility of corporate managers. What is the gist of that? Here is how one (now widely utilized and relied upon) on line encyclopedia, Wikipedia, explains CSR:

Corporate social responsibility (CSR) is an expression used to describe what some see as a company's obligation to be sensitive to the needs of all of the stakeholders <<http://en.wikipedia.org/wiki/Stakeholders>> in its business operations.

A company's stakeholders are all those who are influenced by, or can influence, a company's decisions and actions. These can include (but are not limited to): employees, customers, suppliers, community organizations, subsidiaries and affiliates, joint venture <http://en.wikipedia.org/wiki/Joint_venture> partners, local neighborhoods, investors, and shareholders (or a sole owner).[ii]

The characterization here assumes that ethics demands of us to serve all those who have an interest in what we may have to offer, that is to say, assume that altruism is true. But is it true? One skeptic has listed some of the questions no stakeholder theorists address. "Why is a corporation regarded as socially responsible or virtuous if it spends funds owned by the shareholders for actions that do not increase shareholder value?" Furthermore, "why not distribute the funds to the shareholders? Who appointed corporations to act as the agent of shareholders' political and ethical preferences?" And "In what sense is it virtuous not to invest in South Africa, Burma, Israel, or whatever other country with government policies that are arguably vile, even though the investment would increase the well being of local employees and residents?" As this skeptic puts it, "The basic language with which the issues I addressed, however, begs these questions." [iii]

And, in consequence, is stakeholder business ethics theory right? Are corporate managers in fact primarily responsible to serve – especially in legally enforceable ways – various people and goals in a society not related to the firm as owners or investors? And must, therefore, business ethics be an oxymoron, given that most businesses do in fact aim to provide economic benefits first and foremost to their owners and investors?

Paradoxes of Altruism

It bears keeping in mind that altruism emerged in response to (a) the doctrine of original sin (Christianity) and (b) the theory of psychological selfishness (Hobbes), as an antidote to self-indulgent self-centeredness. If this idea is wrong and human beings do not innately favor themselves, altruism is in a way superfluous.[iv]

Let me address our question by starting with the observation of the poet W. H. Auden, who is reported to have said: “We are here on earth to do good for others. What the others are here for, I don’t know.”[v] This quip, albeit no more than that, suggests a fundamental paradox with altruism. So, again, should we, then, live for others? This is doubtful if for no other reason than that altruism itself promotes well-being, only not of the agent but the patient. Which raises the question why is the patient’s welfare to be privileged by agents even though both are human beings. So the paradox is that if altruism is correct, then everyone ought first and foremost think of benefiting others (and, as Peter Singer would contend, not just other people but other animals[vi]) but then, properly, an endless chain of someone providing for another is to be created and no one may benefit, since everyone is obligated to give everything away to others, especially those who are in need. Peter Unger has spelled this out quite explicitly when he wrote, “On pain of living a life that’s seriously immoral, a typical well-off person, like you and me, must give away most of her financially valuable assets, and much of her income, directing the funds to lessen efficiently the serious suffering of others.”[vii] Once that has happened, everyone must look for the next seriously wanting person, of which there are bound to be some no matter how much giving occurs, if only because of the fact of scarcity, endless human desire and the serious diminution of productivity stemming from the fact that no one may keep the bulk of what he or she produces. (All this may make sense if individualism is totally rejected and we are all parts of a herd wherein the main objective is to sustain the herd even at the expense of individuals. The idea of individual rights is thus banished.)

It bears noting that Singer acknowledges that the ethics he advocates – one that “will require greater altruism on the part of mankind than any other liberation movement” – is very difficult if not quite impossible to practice[viii] and if for that reason alone, it could also be an unwarranted moral stance. Any ethics that “holds out no inducement” and “does not tell us that we will become healthier, or enjoy life more,” may well not be an ethics for human beings living on earth at all.[ix] The ethics of Aristotle, for example, promises that if one practices the virtues, as one clearly should, one will flourish in this life, here on earth. This means that, for Aristotle ethics is by definition a guide for us to aspire to succeed in our lives as human beings. And other schools of ethics, such as utilitarianism, promise at least to benefit us collectively. Altruism, in contrast, seems to require that everyone “discount altogether his own pleasure or happiness

as such.” And that suggests that altruism implies a kind of anti-ethics, an asceticism, even.

As such, if altruism is the proper ethics for us to follow, it does appear that the concept of business ethics is an oxymoron. So would be medical ethics, engineering ethics, legal ethics, and educational ethics – indeed, any branch of ethics that aims to guide professionals to do their work properly since they all do assume, implicitly, that the productive work of these professionals is ethically unobjectionable, that it is moral – prudent! – to do economically well in human life.

Stakeholder Business vs. Professional Ethics

In contrast with other professional ethics, business ethics has recently come under the influence of the stakeholder management school, one that, as we have seen, requires that people in business think not of those who hired them, not themselves even, but of everyone else, anyone who may have a stake in the enterprise. Take, as an example, the recent book by Joseph W. Weiss, *Business Ethics, A Stakeholder and Issues Management Approach*.^[x] It unabashedly treats the stakeholder approach as the proper ethics for managers of business enterprises. Which is to say, it rejects from the outset the idea that those who own a business have the moral right to have it managed so as first of all to provide them with returns on their investment. This book, meant to be used in business ethics courses, shows a diagram indicating who all are stakeholders of businesses. Among the 12 parties considered stakeholders, the owners are treated as equal to, say “Activist Groups,” “Competitors,” and “Government.”^[xi]

Would this function as ethical guidelines for artists, scientists, engineers, and doctors? Should all these divide their focus among innumerable potential beneficiaries as supposedly business is required to do? Engineers are supposed to focus on competently, honestly, and conscientiously, providing services to those who hire them, as are doctors and scientists and even artists (when they are working on commission, for example). In the case of artists, whatever ethics should guide them, one provision of it would surely be that the artists “follow his or her muse” (or vision), not “serve the public”!

Stakeholder theory, following the altruist school of ethics, requires of professionals in business to address the problems and demands of anyone whom they could benefit. This point is advanced, as well, in Joseph DesJardins’ *An Introduction to Business Ethics*, 2nd Edition,^[xii] in which the author defends the stakeholder approach. He notes that the “stakeholder

theory rejects [the] privileged position for stockholders.” Although, as he puts it, “Stockholders do have an ethical claim upon managerial decisions and this claim does establish a duty toward them,” these claims “must be balanced against any comparable ethical claims of anyone else affected by managerial decisions.”[xiii] This, of course, flies in the face of the rights to private property and free association, rights which then authorize individual human beings to have the final say as to what happens to what they own (provided no one’s negative rights are violated in the process) with whom they may enter into mutual voluntary professional relationships.

Imagine that a car rental company sells me the privilege of using one of its cars but were looked upon from this stakeholder viewpoint. Renters would not have to return the car to the company but might well be obligated to hand it over to anyone with “comparable ethical claims” affected by the decision of the rental company to keep their cars to themselves and select their customers. Millions, of course, would wish to have those cars but because they do not own them, they do not get to have them unless they meet the owners’ terms.

Imagine, too, if when one hires an attorney or dentist or gardener, the terms of the relationship would have to involve demands placed on the parties by strangers – neighbors, fellow citizens in need to legal advice or dental care. Yet in the business ethics community such elementary notions of individual rights are rejected, based, in part, on the fact that various laws have been enacted limiting these rights. In the field of law there is, of course, the practice of pro bono work but it is based on the idea of generosity, of voluntary service, not of ethical – let alone legally enforceable – obligations to other than paying clients.

Laws, of course, are made for a great variety of reasons and in a nearly unlimited democracy – not to mention more totalitarian systems – they often flatly contradict ethics.[xiv] In response to such considerations, however, DesJardins states that “these legal precedents did not simply fall from the sky. It is the considered judgment of the most fundamental institutions of a democratic society, the courts and legislatures, that corporate management must limit their fiduciary duty to stockholders in the name of the rights and interests of various constituencies affected by corporate decisions.”[xv] That is a response that construes widespread opinion – considered judgment – decisive and the argument from human nature and natural rights as well as other arguably sound schools of ethics irrelevant.

We could call this the lynch mob approach to ethics. Majorities and their leaders override elementary principles of justice. Because the idea that what is mine is mine and it is I who gets to say what happens to it, in free relationship with willing others, is indeed elementary and fits best within the system of political economy that protects the rights of share or stockholders and accords stakeholders the respect of their basic rights but no decisive influence in how private property will be used and disposed of. But this account, owners enjoy exclusive rights of decision as to what is to be done with what they own and invest.[xvi] Nonetheless, many professional business ethicists ignore this point routinely in our time. Why so?

There is no room to address this question in full – I have done this elsewhere already.[xvii] Suffice it to note that normally business is so unabashedly focused on producing wealth for those who own it, never mind what use they may make of it, that the widespread belief that morally good conduct should – indeed, as some would have it, must – be directed toward benefit others comes into conflict with it from the start.

One can treat engineering, medicine, law or education as professions that “serve others” by their very nature, although there are problems with that idea – after all, those entering the professions could well be doing – and arguably most often do – so in order to enhance their chances of flourishing in their lives (of fulfilling some personal ambition, realizing a talent for something, etc.). If one considers the decision to enter a profession as being based in large measure on factors such as personal preference, personal ambition, talent, the urging of one’s family and friends, and so forth, the apparently unselfish motivation for entering service professions disappears.

Business as a “Selfish” Profession

It is, however, difficult to disguise the open, unabashed “selfishness” of a profession that aims to produce wealth for those for whom it is conducted, the clients, as it were, of those who hire managers of corporations, the small entrepreneurs, and so forth. At even the simplest level – say when one shops at the grocery store, the farmer’s market or at the mall – commerce is directed, unapologetically, toward making a good deal for the various parties involved. Moreover, because of its focus on worldly, mundane goods, commerce and business have always been found to be something of a distraction from what is deemed to be more important, namely, preparing for the afterlife, readying one’s soul for everlasting salvation.

Of course, this view of commerce and business as being exclusively concerned with one's own welfare and advantage is itself problematic, since for millions of people obtaining wealth for themselves amounts to but a first step of the allocation and distribution of that wealth. One need but consider such highly visible wealthy individuals as Andrew Carnegie, Andrew Mellon, Bill Gates, and Warren Buffet, to start with, and then nearly anyone who is prosperous, so as to realize that personal wealth is very often spread out to support a large "stakeholder" community, directly or indirectly – family and friends, organizations being chosen for philanthropic benefit, causes involving artistic, cultural, scientific projects, and, of course, employees, subcontractors, and their families and associates who benefit from distribution of personal wealth.

Yet, even if those who are the rightful owners of the wealth being invested in companies – the managers of which owe a fiduciary duty to them to enhance value – were to keep the created wealth all to themselves, it is a non sequitur to claim that there is something ethically wrong going on that ought to be remedied via law and public policy.[xviii] Consider that many artists pursue artistic projects in complete oblivion to who might or might not benefit from work they put into their creations. The same is true of other people whose lives and works support various chosen goals. No one ought to have any enforceable claim to such lives and works other than those who are their owners. Involuntary servitude is contrary to the principles of a free society.

There is, in short, no sound case afoot that clinches the case against the idea of business as a capitalist system, with owners having decisive authority to allocate their resources and their professional associates, such as business managers, a fiduciary responsibility to serve those owners to whom they have freely chosen to devote their time and skills.

We might mention the more religious or spiritual concerns about commerce and business, namely, that the latter can distract from the important task of readying oneself for the afterlife. At least within most Western religions it is accepted that being guided to live a successful life here on earth is worthwhile. Moreover, readying oneself for ultimate salvation is not what might be construed as stakeholder ethical stance, either, given that the beneficiary will be one's own everlasting soul.

So, business ethics as the guide to conducting commerce and business both decently and successfully, is every bit as legitimate as the ethics of medicine or engineering that guides those professionals along such lines. Nor is it a sound approach to demand of business managers that they work not

for either themselves, as in a small private firm, or their clients, stockholders and investors, but for others who may have a stake in – that is, who could reap benefits from – the enterprise but have no ownership rights in it.

There is nothing wrong with being attentive to these stakeholders' desires but that is not the first order of business of managers of commercial enterprises. Contrary to altruism, this indeed reflects the common sense ethics that guides most human beings at most times, whereby one's first task is to excel at living one's life but whereby this by no means precludes concerning oneself with more or less intimate others, even strangers when time and resources permit.[xix]

Is Business Especially Susceptible to Malpractice?

In a recent exchange on a business ethics web site, there was occasion to explore the general issues of the nature of business and a portion of this exchange will serve to conclude this discussion. One party to the discussion made the following point:

Machan's ... point concerns "the misguided idea that business per se lacks moral or ethical value, that those in the profession do not do what is ethical as they practice their profession." There is an ideal ... that the practice of business is, or can be a vocation in the true sense, a calling. The point is that it can be. But it need not be. One of the fascinating aspects of the business arena is that the doors are not barred to those whose only motive is profit and material gain. (The film *Wall Street* raises these issues in a very entertaining way, and very much from a moral perspective.) This is not a 'good' thing or a 'bad' thing because it is part of the package. For the majority, the motivation is complex, not simple: to provide for oneself and one's family, certainly, but equally to contribute to the wealth of society as a whole by playing a necessary and valuable part in the economic process.

My response to this comment was that, basically, any profession may be taken up for amoral or even morally pernicious reasons – just consider, as an extreme case, when organized criminals enter some legitimate line of work. At a less severe level, too, people may take up education or medicine for ulterior motives – they may wish to escape physical labor or to ogle young students or, in the case of medicine, seek to be depended upon, in a psychologically insidious fashion, by patients.

So the final point I wish to stress is that embarking on what I like to call the wealth care professions (broadly referred to as business – analogous to the health care professions broadly called medicine) – is honorable. There is nothing wrong and much that is morally right with (a) wanting to prosper

in life and (b) seeking to specialized in serving others in the capacity of an expert to facilitate this objective. There is nothing necessarily selfish, in the insidious, narrow sense, about committing oneself to enhancing one's own or other people's prosperity, any more than about committing oneself to enhancing one's own or other people's health – both objectives are “selfish” in a sense of being motivated by prudence, one of the major Aristotelian virtues.

Altruism isn't a hands down winner among the various competing moral or ethical schools of thought. Quite the contrary – it is a misanthropic way of life and whatever plausibility it has is well taken care of within a eudaemonist ethics and its virtues of generosity and liberality.

CSR, the Writers' Strike & Prudence

I have already noted that in the field of business ethics there is a very influential movement called stakeholder theory or, alternatively, corporate social responsibility. The gist of the idea, as we have seen, is that when corporations are being managed, the managers have a fundamental obligation to serve those who have an interest in how the company is doing. So, in contrast to the idea that management ought to seek to advance the best interest of those who own or have invested in the company, this view holds that management ought to look out for the best interest of those who have a stake in the company, who could be helped by it, such as employees, customers, subcontractors, neighbors near plants and office buildings, and so on.

Upon close scrutiny it is evident that the target of this movement is the idea of the right to private property, the idea that when one owns something, one may determine what should happen with it (within the limits of everyone's rights). Shareholders own the company and together ought to be free to provide its direction. Instead, stakeholder theorists claim, it should be politicians, bureaucrats, pundits, preachers, and others in the population who should give companies their direction, their purpose.

We have seen that at the foundation of this movement lies the idea that people owe their lives, their labor, their property to others, first and foremost. This is the ethics of altruism, a favorite of many moralists but also an ethical doctrine that is ultimately impossible to practice consistently, as W. H. Auden observation clearly implies. Not that stakeholder theory is identical to altruism but its underlying rationale arises from that ethical school, one according to which everyone owes service to others, first and foremost.

The people who advocate this altruistic ethics, especially as it influences

the way businesses are being managed, are those on the political Left. And the political Left in American includes, more than most professions, those who write the scripts for Hollywood movies and television dramas. If you check out the moral orientation of most Hollywood fare, it is plain to see that it promotes the idea that businesses shouldn't seek to make profit but aim to help those in need.

The heroes in Hollywood aren't the suits who bring in the dollars (and create the jobs), not by a long shot. The heroes are the actors and actresses who gallivant around the globe offering help to the needy and put down concern with the box office and commercial success. The fact is largely ignored that they couldn't do their philanthropic work without the profits that the suits make possible for all these actors and actresses. As with Mother Teresa versus Bill Gates, never mind that the former could barely help a few people while the latter has created decent jobs for millions and useful tools for the rest of us. Looking good, in terms of the altruists, seems to trump actually doing real good!

Yet, there is a glitch here, as the writers' strike reveals. Suddenly the fact that this strike has virtually crippled the entertainment industry cuts seems not to matter to the writers' union and membership. Never mind all the stakeholders who are losing work and cannot pay their bills because the writers are insisting on pursuing what they perceive to be their own economic interests. In short, where is the "social responsibility" of the writers, their unions, in this current strike? Why is it OK for them all to focus on their own economic well being, their economic future, on what benefits them and their loved ones? Why, if corporate managers are acting badly in advancing the economic interest of those who own and invest in their companies, aren't the writers and their union leaders acting badly by trying, with this prolonged work stoppage, to advance their own economic interest?

Why are the writers and their union leaders not renouncing self-interest and profit and going back to work for the benefit of all the stakeholders? Is it, perhaps, that they aren't actually very serious about their altruism? Is it perhaps that when it comes close to home they agree with W. H. Auden's point that altruism is an impossible guide to human conduct. It is one thing to give lip service to it and to denounce those who seek to make a profit from their work; it is another thing entirely to walk the talk and abandon the pursuit of profit by, for example, stopping the writers' strike.

Of course, the writers have every right to strike--although with the oddities of mandatory unionization their strike has a good many perverse elements. But it would be cool if they admitted that when it comes to their

own economic well being, altruism isn't their ethical guide and egoism is and they are doing exactly what those "greedy" suits are doing whom they are always putting down in their writings.

Endnotes:

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- [i] W. G. MacLagan, "Self and Others: A Defense of Altruism," *Philosophical Quarterly* 4 (1954): 109-127.
 - [ii] http://en.wikipedia.org/wiki/Corporate_social_responsibility
 - [iii] William A. Niskanen, "Corporations As Suppliers of Public Goods" (Review of David Vogel, *The Market for Virtue, The Potential and Limits of Corporate Social Responsibility* [Washington, DC: Brookings Institution Press, 2005]. http://findarticles.com/p/articles/mi_hb262/is_200512/ai_n25946488.)
 - [iv] Judging by the troubles of humanity, it does not appear that people are inclined, innately, to be self-interested or prudent, quite the contrary.
 - [v] <http://www.brainyquote.com/quotes/quotes/w/whauden161273.html>
 - [vi] Peter Singer, "Animal Liberation," *New York Review of Books*, Vol. 20, No. 5 (April 5, 1973) and Peter Singer, *Animal Liberation* (New York: Hearst Corporation, 1991). The passage in question by Singer is very revealing. He notes that he could not promise that "we will become healthier, or enjoy life more, if we cease exploiting animals. Animal Liberation will require greater altruism on the part of mankind than any other liberation movement, since animals are incapable of demanding it for themselves, or of protesting against their exploitation by votes, demonstration, or bombs." Singer goes on to ask, rhetorically one may assume, whether "man is capable of such genuine altruism? Who knows? If this book does have a significant effect, however, it will be a vindication of all those who have believed that man has within himself the potential for more than cruelty and selfishness."
 - [vii] Peter Unger, *Living High and Letting Die: Our Illusion of Innocence* (NY: Oxford University Press, 1996).
 - [viii] Even Mother Teresa admitted that she gained joy from helping others, thus raising the question about whether her motives were truly altruistic.
 - [ix] Interestingly, Singer wants us all to prize other animals more than we prize ourselves, yet most other animals are hard wired to prize themselves far more than they prize their fellows in the animal world. (For more, see Tibor R. Machan, *Putting Humans First, Why We Are Nature's Favorite* [Lenham, MD: Rowman & Littlefield, 2004].)
 - [x] (Mason, OH: Thomson South-Western, 2006.)
 - [xi] *Ibid*, 56.
 - [xii] (New York, NY: The McGraw-Hill Co., 2006)
 - [xiii] *ibid.*, 66-67. The term "comparable ethical claim" begs the question – if altruism and stakeholder theory are wrong, an ethical claim may have to meet, first of all, the standard of fulfilling an obligation voluntarily made by managers to shareholders (my emphasis).
 - [xiv] For how this has wrought havoc both at home and in the international community, see Fareed Zakaria, *The Future of Freedom: Illiberal Democracy at home and abroad* (New York: W. W. Norton, 2003).
 - [xv] Opt Cit., DesJardins.
 - [xvi] There are, of course, important consequentialist, utilitarian reasons, as well, for preferring the share or stockholder approach. They include considerations of the tragedy of the commons, of proper incentives that lead to the productivity of a property rights based, capitalist economy, of individual responsibility that accompanies ownership, etc., etc.
 - [xvii] See, for example, James E. Cheshier and Tibor R. Machan, *The Business of Commerce, Examining an Honorable Profession* (Stanford, CA: Hoover Institution Press, 1999), and Tibor R. Machan, *The Morality of Business, A Profession for Human Wealthcare* (New York, NY: Springer Verlag, 2007).
 - [xviii] It is noteworthy that stakeholder theorists do not claim that it is the obligation of stakeholders to share in the losses of companies the management of which must benefit stakeholders just as much as shareholders.
 - [xix] This is indeed the contemporary version of Aristotelian morality spelled out in Tibor R. Machan, *Classical Individualism, The Supreme Importance of Each Human Being* (London, UK: Routledge, 1998).

Discussion Questions

1. Do you agree with the author that a company pursuing CSR is “wrong”? Why or why not?
2. Do you think the author is right when he equates CSR with stakeholder theory? Why or why not?
3. What do you think is the purpose of business? Do you think the purpose has changed over the last 50 years? If so, why and how?

BIOGRAPHY



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Chapter 5

Corporate Governance and the Community: The Shifting of Risk

William Martin

Abstract

In the US, employer contributions to health insurance are frequently part of the employment package. However, with the costs of health insurance and health care on the rise, employers are looking at ways of reducing their costs – often by directing employees to a defined contribution rather than a defined benefit fund. This shifts the risk from employers to employees but raises potentially serious issues around affordability and coverage for the employees and more importantly, around the responsibilities the employing organization owes and to whom; a question of governance. Drawing on concepts of stakeholder theory and CSR, this chapter explores these issues for a healthcare provider and their broader social implications.

Introduction

WorldCom. Enron. AIG. HealthSouth. Lehman Brothers. BP. Unfortunately, the list of ethical scandals tarnishing the reputations of executives, board members, and organizations is far too long and reaches around the globe. To protect economies and the public, governments implemented legal and regulatory measures such as Sarbanes-Oxley Act in 2002 in the United States, the EU Corporate Governance Framework (via a the Green Paper) by the European Commission, and the third King Report on Corporate Governance in South Africa (Institute of Directors, 2009).

In response to these macroeconomic shocks since the financial crisis of 2008 and even before during the dotcom crash of 2001, corporations for-profit and not-for-profit have sought ways to increase revenue and cut costs. Defined Benefit (DB) pension plans have been on the agenda as one way to cut costs (Meagher and Jacobs, 2011).

In the early 1980s, most workers were covered by a DB plan; today most workers have a Defined Contribution (DC), such as a 401(k), 403(b) or 457 plans, as their chief or only plan (Gustman, Steinmeier, & Tabatabai, 2011).

Furthermore, some researchers have concluded that the shift from DB to DC plans is a concern (Munnell, Golub-Sass, & Webb, 2007; Munnell and Sunden, 2004, 2006) as evidenced by the following: risk is shifted from the employer to the employee and most workers have smaller balances in their DC plans than what they would have had in a DB plan. Employer contribution costs under a DC plan are based on a fixed formula in contrast to fluctuating investment returns under a DB plan. As such, the United States retirement system is akin to a “three-legged stool,” consisting of the Social Security, employer-provided plans, and individual savings. The focus here will not be on Social Security or individual savings but employer-provided plans. An illustrative case will be presented focusing upon a senior leadership decision approved as a resolution by the Board of Directors of a not-for-profit, healthcare organization regarding whether to continue to offer a DB plan or convert to a DC plan. This governance decision occurs within the backdrop of the United States with its “three-legged stool” as the platform for retirement income.

The Financial Crisis: Acceleration of Governance Decisions

Since the 1970s, median individual incomes have been declining in the United States although these incomes have been bolstered by the increase in dual earning couples (Fukuyama, 2012). However, the financial crisis of 2008 signaled a new era in the governance of both nations and corporations as stock markets plunged, home prices tumbled, retirement balances vanished, and personal savings disappeared. The reality for many Americans, after the financial crisis of 2008, is portrayed by Fukuyama (2012).

“... the bursting of the housing bubble in 2008-9 was nothing more than a cruel reversion to the mean. Americans may today benefit from cheap cell phones, inexpensive clothing, and Facebook, but they increasingly cannot afford their own homes, or health insurance, or comfortable pensions when they retire (p. 6).”

The question confronting governments and, increasingly, organizations is this: who is responsible and accountable to this financial reality of falling incomes for many Americans and others throughout the world? In the United States, most workers are dependent upon organizations to earn income. This earned income is then used to purchase their homes, obtain health insurance and provide a significant proportion of their retirement income. And organizations are dependent upon workers to generate revenue,

lower costs, and enhance productivity. In short, workers and organizations depend on one another in a way that is symbiotic. Langella and colleagues (2012) describe the nature of symbiosis in biology below:

“...symbiosis describes two unlike organisms living together, and one can distinguish between parasitism and mutualism. In the former only one organism benefits at the expense of the other, while in the latter both organisms benefit from the symbiosis (page 51).”

These authors further assert that “With decisions on wages, corporations influence poverty and wealth dispersion (page 51).” Given the interdependence between organizations and their workers, it will be argued here that good governance extends beyond doing that which is best for the organization to which is best for workers and even retirees as well as their dependents.

Illustrative Case: Healthcare Organization

One of the largest healthcare organizations in the United States consisting of a medical group, hospitals, and other health care establishments such as pharmacies will be used to illustrate how good governance has an impact on both a diverse set of stakeholders but also a defined community. The decision to be illustrated here will be whether the board should maintain a Defined Benefit (DB) retirement plan or to convert the plan to a Defined Contribution (DC) plan.

The Board of this not-for-profit healthcare organization which happens to be one of the largest private sector employers in the State and is headquartered in the largest city in the State was well aware that this decision would be scrutinized by numerous stakeholders ranging from employees to the media. In the end, the Board of this healthcare organization approved a resolution to end its traditional pension plan, that is, DB plan. The contributions of the employees were redirected to a DC plan. In short, the DB plan was frozen at the close of the 2012 fiscal year. The publicly stated reasons for this change were the following:

1. The unpredictable nature of funding a DB plan due to economic and market volatility.
2. Shorter length of service or tenure among employees today than in years past.
3. The attractive nature of a more flexible plan such as a DC plan allowing employees to move from one employer to another with greater ease.

Given the not-for-profit status of the organization, for which it is exempt from paying federal and state taxes, another question facing the board is what is the impact of this decision on the financial health of the communities in which it operates. Should good governance consider only what is best for the financial health of the organization and/or what is best for the financial health of the larger community? In other words, is the relationship between this healthcare organization more parasitic or mutualistic?

The answers to these questions are complex. Complexity is the agenda confronting senior leaders and boards of directors. To respond to these questions, the board must determine the social impacts of their decisions including decisions which fall under the category of financial and even human resources management such as changing the retirement plan. It was argued by some of the board members that because of the not-for-profit structure of the organization and the fact that it provides healthcare that the organization had met all of its responsibilities to the larger community.

Landrum, Gardner, and Boje (2013) identify different types of social impact strategies. One of these is what happens to employees as stakeholders. Simply because this healthcare organization delivers healthcare does not give this organization a pass on the other social impacts such as the treatment of employees as stakeholders. This was an issue of debate among the board. Low and Ang (2013) describe the relationship between social impacts and stakeholders below from a governance perspective:

“In other words, the leaders of an organization choose to be socially accountable to their stakeholders [labour] (page 32).”

This is the choice facing the board of directors and executive leadership at this healthcare organization. This choice must be diligently and systematically addressed using the guideposts of two theories: Corporate Social Responsibility (CSR) and Stakeholder Theory (SH). In the end, good governance is an outcome of the process and impact of the decisions of boards and executive leaders as assessed by key stakeholders. It must be stated up front that the board did not label their discussions, deliberations, debates and decisions as involving tenets of CSR and SH but in fact a narrative analysis would reveal that these tenets were central to the decision by the board.

The board also knew that this decision would be judged internally in the organization by employees and in the wider community by family members, the media, politicians, and even patients. Researchers have established that

workers care about the fairness of outcomes and consider distributive justice in determining fairness (Adams, 1965; Greenberg, 1998). Moreover, Miceli and Mulvey (2000) found a positive relationship between pay satisfaction and distributive justice. The board recognized that the fairness of this decision would be scrutinized by many and diverse stakeholders including other board members.

Human resources leadership warned the board about the impact of this decision on future employee performance and productivity. Heneman and Judge (2000) concluded in an exhaustive review of the literature on pay satisfaction including benefits that "...pay dissatisfaction can have important and undesirable impacts on numerous employee outcomes (page 85)."

Corporate Social Responsibility (CSR) and Stakeholder Theory: A Conceptual Nexus

Both Corporate Social Responsibility (CSR) and Stakeholder Theory (SH) will be used to establish a framework by which this governance choice can be analyzed and evaluated. In this illustrative case study, the choice confronting the board of directors was whether to convert the DB plan to a DC plan. This was a strategic decision for the organization but also a decision with significant ripple effects on the retirement security and economic well-being of a community.

The relationship between CSR and SH is quite straightforward. There are numerous and varied definitions of CSR. The definition used in this paper is drawn from the World Business Council for Sustainable Development. CSR is defined as, "Corporate social responsibility is the commitment of business to contribute to sustainable economic development, working with employees, their families, the local community and society at large to improve their quality of life (WBSCD, 2002). This definition refers to both internal and external stakeholders. In essence, Jones and George (2008) established both shareholders and stakeholders hold companies accountable for CSR activities and impacts. To this point, the Internal Revenue Service which is the tax authority in the United States allows not-for-profit organizations to be exempt from paying federal taxes as long as they demonstrate a benefit to the community. For many not-for-profit healthcare organizations, including the one in this illustrative case study, there is a financial rationale for embracing CSR.

To establish CSR requires more than a proclamation or announcement on the part of an organization, key internal and external stakeholders pass judgment based upon their criteria as to whether an organization is

behaving in a fashion that would be described as socially responsible. Low and Ang (2013) assert that it is stakeholders who decide the degree to which a company is fulfilling its CSR commitments. Specifically, they argue that internal and external stakeholders make this assessment by evaluating the behaviour of the company in question as described below:

“Most will look at what the company has actually done, good or bad, in terms of its products and services; how it treats and develops its workforce; and what its activities have impacted on the environment and on local communities (page 33).”

The decision to freeze the DB plan signaled to the community how the organization, the board, and senior leadership treated its workforce and what type of impact would be felt by the community both economically and psychologically with regard to feelings of retirement security or confidence.

In essence, Branco and Rodrigues (2007) argue that CSR and stakeholder theory are not mutually exclusive but interrelated as illustrated below:

“The present-day conception of corporate social responsibility (CSR) implies that Companies voluntarily integrate social and environmental concerns in their Operations and interaction with stakeholders (page 5).”

Furthermore, they posit that “...the stakeholder perspective has become something which is inescapable if one wants to discuss and analyse CSR (Branco & Rodrigues, 2007, page 5).” This conceptual linkage between CSR and SH begs the question-What is the relationship between good governance, CSR and SH? Sternberg (2009) replies, “Corporate social responsibility is often associated with hopes for improved corporate governance (page 1).”

Good Governance: A Definition

There is no universally accepted definition of good corporate governance, a situation that affects both the field and practice of governance (Turnbull, 1997). However, for the purposes of this chapter, the following definition will be applied.

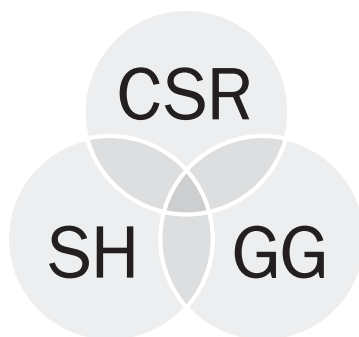
“Good governance within an organization reduces risks, increases performance, opens the way to financial markets, brings competitive goods and services on the market, improves the managerial style, and shows transparency to all the interested parties and social responsibility (Cretu, 2012, page 624).”

Even if there is disagreement about the most applicable governance theory and even if there is a lack of consensus about whether boards of directors

will act in an ethical fashion given the recent attention to ethical scandals, there is emerging agreement to the notion that the board is responsible and accountable for the strategic leadership of ethical behaviour of the organization (Llopis, Gonzalez & Gasco, 2007; Thomas et al., 2003). Increasingly, the ethical behaviour of an organization and the board which provides oversight of the organization is being viewed from a broader perspective than simply meeting the expectations of shareholders and internal stakeholders.

As stated above, there seems to be a growing recognition of the conceptual interrelationships among CSR, SH, and good governance. The intersection among the three is represented in Figure 1. At the intersection among all three is distributive justice. This has become a neglected area of inquiry among CSR scholars (Blockson, 1988). However, Sternberg (2009) asserts that "...ethical business must seek to maximise owner value, subject only to respecting distributive justice and ordinary decency (page 9)."

Figure 1: INTERRELATIONSHIPS AMONG CSR, SH, AND GOOD GOVERNANCE (GG)



As you will note in Figure 1, the impact on society is where all three converge as. Frankental (2001) recognizes this converging relationship below:

“Corporate social responsibility, however, one chooses to define the term, implies that a company is responsible for its wider impact on society (page 19).”

It is necessary that boards hold themselves and senior leaders responsible and accountable for overseeing the strategic direction, providing oversight of executive leadership, and managing the reputation of the organization through two lenses: impact on the organization and impact on society. Assuming that boards of directors rise to the challenge, then the issue becomes how to actually govern in a way that provides greater assurance

that the impact of society is being considered when boards make decisions. A useful framework is the “bad apple” versus the “bad barrel” framework (Trevino & Youngblood, 1990).

Good Corporate Governance: Bad Apples, Bad Case or Bad Barrel

This is a well-known framework within the business ethics literature. In a meta-analysis of 136 studies (Kish et al., 2010), the findings reveal that unethical decisions and behaviour arise from multiple sources not a single source. In short, good corporate governance ought to have mechanisms in place to guard against the “bad apple,” the “bad case,” and the “bad barrel.” Moreover, it was also empirically demonstrated in this meta-analysis that unethical decisions and behaviours arise from impulsive processes as well as deliberate processes (Kish et al., 2010). As such, ethical impulsivity will also be explored because it either arises from a “bad apple”, a “bad case,” or a “bad barrel” or has an impact on the individual, the issue at hand, and the organization.

Given the multifactorial nature of unethical decisions and behaviours, this chapter is organized around each of the four major sources of unethical decisions and behaviour. After exploring each one of these sources, a case will be presented to apply how these four sources come together to yield what some may regard as an unethical or ethical decision or behaviour. In the end, recommendations will be shared with executives, board members, and academics on how to enhance the ethical decisions and behaviours of boards and the executives that are accountable to boards. In the end, it will be assumed here as posited by others (Sankaran & Iyer, 2011) that boards need to be accountable “...to its stakeholders, including shareholders, employees, customers, suppliers, regulators, and the community (page 149).” Again, this assertion acknowledges the interrelationship among CSR, SH, and GG.

Good Corporate Governance: Preventing Bad Apples

Given that good corporate governance is the sum total of individual decisions and behaviours, focusing upon individual board members is important. Spitzbeck (2009) argues that boards ought to hold CEOs responsible and accountable for taking a leadership role on matters related to Corporate Social Responsibility (CSR). In some cases, grappling with issues related to ethics and CSR is not an individual matter but delegated to a committee such as a CSR committee (Strandberg, 2008). In far too many cases, there is an over-emphasis on laying blame on individuals rather than looking at the role of collective decision making which is far more

common when boards make decisions than executives and the role of the ethical culture/climate of the board. These aspects will provide the focus of the following section.

Good Corporate Governance: Addressing Bad Cases

Good corporate governance also focuses upon the manner in which specific decisions are made on particular issues. This point of view is more granular than focusing upon “bad apples” or “bad barrel” alone. In short, posed as a question, the decision facing the board was: Do we convert our DB retirement plan into a DC retirement plan? Table 1 shows the impact of this decision on three key stakeholders: management, employees, and lenders/bankers.

Before detailing the specific of this illustrative case, when boards wrestle with a case which is framed as involving ethics, it is critical that boards do not artificially separate doing good from making a profit. This is difficult for boards to actually carry out in practice due to yielding to the philosophy of well-renowned economists such as Milton Friedman who wrote in a New York Times article, “There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase profits so long as it stays within the rules of the game (page 230).” This view must be tempered with an alternative view including a stakeholder approach (Freeman, 1984).

A stakeholder approach not only increases representativeness but it also has the potential to reduce conflict (Rothman & Friedman, 2001). An effective stakeholder approach is only as good as to the degree to which it is incorporated into the decision making processes of boards as observed by Spitzeck (2009) who writes, “Corporations will not act responsibly as long as corporate responsibility issues are not integrated into their decision making and governance structures (page 495).” One such issue which will be the focal point of the illustrative case study that follows is the social impact of pensions (Spitzeck, 2009).

One of the challenges confronting boards is deciding whether a particular issue meets the criteria of being an ethical decision or not. According to Jones, if an individual may be harmed or benefit from a decision, then it is an ethical decision. Furthermore, the individual or group making the decision are moral agents (Jones, 1991). An ethical decision is defined as “a decision that is both legal and morally acceptable to the larger community” whereas an unethical decision may be regarded as “either illegal or morally unacceptable to the larger community” (Jones, 1991, p. 367).

Good Corporate Governance: Preventing Bad Barrels

Decision making in a board occurs because of two factors: individual decision making and collective decision making. Acting alone, an individual director “has no power of his own to act on the corporation’s behalf, but only as one of the body of directors acting as a board (Restatement).”

Vuontisjarvi (2013) presents four arguments that organizational decision make when faced with challenges such as downsizing, or in this case, freezing a DB retirement plan: rationalization, normalization, inevitability and emotional/moral distancing. Parker (2007) discusses how boards must define and monitor the ethical culture and climate of the organization and the board itself. Moreover, Llopis, Gonzalez and Gasco (2007) emphasize the importance of a governance ethical culture which is defined below:

“We are thus firmly convinced that corporate governance ethical culture must necessarily include the conversion of the CEO and all the senior managers into symbolic EOs (executive officer), which will reinforce and give sense to the formal appointment of an EO (page 102).”

Furthermore, the board is in the unique position to change or improve the ethical values of an organization (Llopis, Gonzalez & Gasco, 2007).

Given the formal authority of the board, should decisions which impact a variety of stakeholders be left in the hands of a single group, that is, the board, or maybe two groups if you include senior leadership? It will be argued here that the answer is no. Arnstein (1969) plotted the decision making power of stakeholders along a continuum from non-participation to real decision making. In a study of 46 companies, it was found that stakeholders have little actual decision making power (Spietzeck & Hansen, 2010). This empirical finding will be illustrated in the case that follows about the DB-DC conversion at one company.

Good Corporate Governance: Preventing Ethical Impulsivity

Recognizing the reality that ethical impulsivity operates in boardrooms is crucial given the bias to assume that individual and collective decisions are rational and deliberative only. Past researchers have challenged this notion. In fact, it is well-established in the behavioural economics and finance literature that managers, and by extension board members, are subject to behavioural biases when making strategic decisions (Dhir & Mital, 2012) and ethical decisions (Rogerson et al., 2011).

These behavioural biases do not suggest in the least that ethics is absent in the decision making of board members but it does suggest that at times

it may be hidden or sidelined (Roberts, 2001). Additionally, given the limits of bounded rationality and the dilemmas associated with satisficing (van Ees, Gabrielsson and Huse, 2009), board members must guard against these impairments to decision making as well as the more psychological barrier of denial. Frankental (2001) argues that denial also influences the decisions related to CSR in general and human rights in particular as pinpointed below:

“When it comes to putting human rights on the corporate agenda, breaking the barriers of denial that companies have to put up becomes a fundamental problem (page 21).”

Table 1 lists the forms of denial operating among key decision makers in companies and the translation of that form of denial (Frankental, 2001) as it relates to terminating a DB plan and converting it to a DC plan.

Table 1: FORMS OF DENIAL RELATED TO DB-DC CONVERSION

Form of Denial	DB-DC Conversion
Lack of conception of what human rights is.	Perspective that equates human rights with legal rights only.
Lack of acknowledgment of their responsibility for the human rights impact of their operations.	Point of view that fails to address the three pillars of retirement: government; company; and individual.
Lack of analysis as to how their operations might impinge on human rights, and how they could use their legitimate influence actively to further human rights.	Standpoint that it is not the responsibility of the board (or senior leaders) to address what happens after employees stops contributing to the organization after they retire.

Denial is not the only barrier to decision making. As discussed above, good governance seeks to prevent, identify, and address barriers to effective and ethical decision making. In one of the few empirical studies of stakeholder governance, it was found that stakeholders need real power to address the issues facing them (Spitzeck and Hansen, 2010). According to Rossouw (2005), “...the way in which a company treats its stakeholders reflect its ethical standards. It is therefore to be expected that companies for whom ethics is a priority will be sensitive to its stakeholders. This moral sensitivity will be reflected in the identification of stakeholders as well as in the manner in which they are being engaged by the company (page 99).” Bonn and Fisher (2005) proposed a framework to incorporate ethical considerations into the work of boards. Chan and Cheung (2012) recognize that “...good CG (corporate governance) is not easy to maintain because it

requires well-designed ethical policies, ethical leadership, and incorporating ethics into the organizational processes and strategies (page 47).”

Brown (2005) in examining the empirical association between non-profit organizational performance and board effectiveness found deliberate attention to group decision making and interpersonal dynamics adds value to the organization. These barriers include but are not limited to the following: “bad apple,” “bad case,” “bad barrel”, and ethical impulsivity. What follows is a descriptive analysis of how these four barriers were factored into the board decision to cease offering a Defined Benefit (DB) plan for future employees while at the same time honoring prior commitments made to current employees.

The End of Defined Benefit Retirement Plans

Across the globe, angst exists about earning a living wage and facing retirement without confronting poverty. In the United States, retirement confidence hit an all-time low in 2012 with slightly more than one out of ten (14%) of Americans reporting they have enough money to live comfortably when they retire (Employee Benefit Research Institute, 2012). Across Europe, it was found that Scandinavians as compared to Eastern Europeans worry less about retirement (Hershey et al., 2010). It was also found that in countries with a high level of income inequality that retirement income worries increased (Hershey et al., 2010).

There exist three pillars to retirement: government-provided retirement benefits; employer-provided retirement benefits; and self-provided retirement benefits. The focus here is on employer-provided retirement benefits recognizing that what companies decide to do falls within the context of what the government offers and what individual employees have saved for retirement as well as their retirement expectations. In the United States, there are two types of retirement plans: Defined Benefit (DB) and Defined Contribution (DC). Schrager (2009) describes how DB plans are decreasing and DC plans are increasing both in the United States and the United Kingdom.

The major difference between a DB and a DC plan revolve around two issues: the voluntary nature of the retirement plan and the certainty of monies received during the withdrawal period. By and large, DB plans are involuntary. In short, employees are automatically enrolled in the DB plan as a condition of employment. By way of contrast, in the United States, DC plans are largely voluntary, even if the company contributes to the plan. With regard to certainty of the amount of money upon withdrawal, DB

plans are formulaic and the retiree knows how much money they will have available during retirement. In contrast, DC plans leave the employee and the retiree wondering how much money they will have available during retirement because the amount depends upon market performance in general as well as the specific tactical investment choices made by the employee/retiree. In sum, individual employees and retirees hold more risk when using a DC plan rather than a DB plan. On the other hand, companies hold more risk when offering a DB plan rather than a DC plan.

In the United States, against the backdrop of the changing psychological contract between employees and employers was a significant change in a tax law. This change has had a tremendous impact on providing a reason for employers to drop DB plans. Issued in September 2006, Statement of Financial Accounting Standards (SFAS) 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans – An Amendment of FASB Statements No. 87, 88, 106, and 132(R)*, significantly changes the balance-sheet reporting for defined benefit pension plans. SFAS 158 requires companies to report their plans' funded status as either an asset or a liability on their balance sheets, which will cause reported pension liabilities to rise significantly. A related concern is the inverse relationship between interest rates and reported pension liabilities. In other words, as interest rates decrease, pension liabilities increase.

Illustrative Case Study: Decision Facing the Board of Directors

The decision facing the board of directors was whether to continue the DB retirement plan or to close the DB plan to all new employees. Whatever the outcome of the decision, there are risks with different types of uncertainty (Schrager, 2009). This decision regarding the retirement plan could be framed as a decision only about employee/retiree benefits or a decision about the strategic direction of the organization more generally. Maritz, Pretorius, and Plant (2011) challenge responsible leaders to make strategy using a deliberate approach rather than an emergent approach:

“In the deliberate strategy-making mode ends and means are well-defined and detailed. This means that organizational risk can be identified in advance and where implementation does not happen according to detailed plans, corrective action can be suggested and taken. In the emergent-strategy making mode ends and means remain vague which makes it more difficult to identify discrepancies in implementation of strategies and consequently increase the risk of non-compliance and failure (page 105).”

A deliberative approach to governance decision making is important because boards have to make decisions that take into account complexity. Complexity takes the shape of anticipating the response of multiple and diverse stakeholders as well as accounting for the impact of the decision based upon the current reality and the future reality. In this illustrative case, a deliberate approach to decision making was taken but not to the degree that it may have been given the relative lack of attention to diverse stakeholders. This is important because decisions about DB-DC conversion plans should be made, if a board is seeking to embrace the tenets of good governance, based upon more than simply focusing upon the financial aspects of the decision such as market volatility and interest rates.

Background: Leading Up to the Decision

For nearly a decade, this not-for-profit health system had questioned whether the DB retirement plan should be maintained or converted into a DC retirement plan. This discussion typically arose when the discount rate dropped, thereby increasing the pension liability on the balance sheet. These prior discussions about converting the retirement plan began in earnest in 2006 when SFAS 158 came into existence. For nearly a decade, consultants would be engaged to deliver presentations to senior leadership and the board regarding the impact of pension liabilities on the balance sheet of the organization.

A balance sheet is a key tool when capital needs to be raised by borrowing in the case of a not-for-profit healthcare organization. Consultants were also reporting that other not-for-profit organizations were either dropping or considering dropping their DB plans. This created two reasons to convert from a DB to a DC plan: (1) financial reason and (2) keeping pace with a reported best practice. To be fair, concerns were always expressed about the other side of converting a DB to a DC plan, that is, how this conversion would relieve the organization of the implicit promises made to employees of the healthcare organization regarding future compensation.

Nature of the Decision: Near-Sighted or Far-Sighted?

The decision made by the board was largely a near-sighted decision focusing on finances in general and the current discount rate as well as forecasted discount rate for the next 2-3 years. A relatively more far-sighted decision would have probed a bit deeper into the impact on these individuals, their families, and their communities beyond a window of

3 years. This type of short-sighted reasoning resulted in leaning toward converting the DB plan into a DC plan because of an unfavorable interest rate. If, on the other hand, the interest rate and the discount rate had been more favorable, then it would be interesting to see if the decision would have been different.

Good governance mandates attention to more than one variable because of the inherent interrelatedness and growing complexity of the world. Meagher and Jacobs (2011) identify various factors influencing the decision to free a DB pension plan including the following: limited reaction from employees; competition; plan complexity; change in corporate philosophy; and following the “leader” trend. For instance, the decision to terminate the DB plan could have negative consequences for this healthcare organization because retirement insecurity and unpredictable cash flow may impact the healthcare seeking and utilization behaviour of retirees who worked for the healthcare organization given the fact that the healthcare organization was the largest employer in the city and one of the largest employers in the State. In short, good governance mandates embracing complexity, untangling interrelatedness, and quilting together often conflicting agendas into a whole.

Another organization faced a similar decision regarding retiree health benefits. The consultants opined and recommended that providing retiree health benefits was passé and detrimental to the financial well-being of the organization. In this organization, rather than solely looking at one factor, that is, the financial point of view, multiple factors were incorporated into the decision. First and foremost was the mission and values of the organization. Second was the history of the organization. Third was the relationship that the organization sought to establish with current employees, retirees, dependents and the community.

Conclusion

Good governance is more essential today than in the past for two reasons. First, the rise of ethical scandals has called into question the decision making quality of boards given the negative impact of board decisions on the financial health of society and the environmental health of society. Second, as governments continue to struggle financially, organizations may be put in the position to pick up the slack and provide a safety net that once was woven together by the government and before the government a safety net was a luxury for a few. Can organizations prosper in the long run when the masses are worried about earning a living, making a living,

finding and staying in a decent home, saving for retirement and educating their children?

Discussion Questions:

1. Whose responsibility is it to fund health care? The individual? Government? Employers? Give reasons for your answer by referring to arguments around the nature of relationships that exist between these parties.
2. What is the role of business in society? Why and how does your description echo or conflict with the position of writers on the subject.
3. What is the author's argument in this chapter? Does he believe that some sorts of employers have a greater responsibility to fund their employees' health care than do others? Give reasons for your answer and identify whether and why you agree or disagree.

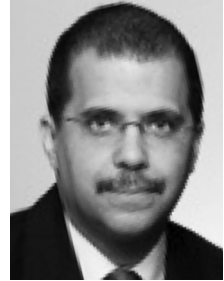
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BIOGRAPHY

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Chapter 6

Governance, Stakeholder Management and Integrated Reporting: A Case Study of the South African Utility Eskom

Christelle Marais & Shaun Vorster

Abstract

In recent years, corporate governance has shifted its focus from being ‘shareholder-centred’ to ‘stakeholder-inclusive’. This ‘stakeholder-inclusive’ approach is emphasised by South Africa’s third King Report on Corporate Governance (King III). King III also recommends the use of integrated reporting as communication vehicle for reporting on an organization’s corporate governance practices and triple bottom line (TBL) performance. Eskom, South Africa’s electricity utility, has embarked on integrating these recommendations with its business practices.

In order to understand whether Eskom has successfully integrated a ‘stakeholder-inclusive’ approach to corporate governance, Eskom’s stakeholder management approach is analysed using Freeman’s (1984) three levels of stakeholder management. Firstly, at a rational level, Eskom’s stakeholder groups and their respective TBL interests and expectations are identified. Secondly, at the transactional level, Eskom’s strategic posture towards these stakeholder groups is assessed. Finally, processes and capabilities implemented by Eskom to manage stakeholder groups are identified at the process level.

Eskom’s 2012 integrated report is used to assess these three levels of stakeholder management.

Based on the analysis at the rational level, it is observed that Eskom addresses most of the identified stakeholder groups and their TBL interests. At the transactional level, Eskom follows a strategic posture of engagement, dialogue and negotiations towards its stakeholders. At the process level, the utility’s integrated reporting process follows the five steps of stakeholder management proposed by Beckett and Jonker (2002). It is therefore concluded that Eskom does by and large follow a ‘stakeholder-inclusive’ approach to corporate governance.

Introduction

Eskom, the state-owned South African electricity utility, regards corporate governance as critical for business success, accountability and transparency (World Finance, 2013). Eskom participated in the development of all three versions of the South African King Report on Corporate Governance. The King Report, or King III, is a principle-based governance framework that emphasises two critical governance factors, namely a ‘stakeholder-inclusive’ approach and the use of integrated reporting. In line with this, Eskom has implemented a stakeholder management process, and uses integrated reporting as vehicle to communicate on corporate governance. Integrated reporting is also used to communicate the integration of social, economic and environmental components of the triple bottom line (TBL) with its business (World Finance, 2013; IoDSA, 2009; Accountancy South Africa, 2012; Eskom, 2011; IDASA, 2010; Jameson, personal communication, 10 December 2012; Rambharos, personal communication, 10 December 2012).

In light of Eskom’s progress in incorporating corporate governance into its business, this chapter considers the following questions:

- i. At a rational level, who are Eskom’s stakeholders, and what are their TBL interests and expectations?
- ii. At a transactional level, how does Eskom respond to stakeholders’ TBL interests and expectations through its integrated report, and what does this say about the utility’s strategic posture towards stakeholders?
- iii. At a process level, how does Eskom manage its stakeholders and the development of its integrated report?

Section 2 briefly reviews the transition of corporate governance from the traditional ‘shareholder-centred’ model to a ‘stakeholder-inclusive’ approach. Section 3 describes integrated reporting and the role of stakeholder management. Section 4 then identifies and maps Eskom’s stakeholders, and records their TBL interests and expectations. Eskom’s stakeholder management process is also described, as well as the responsiveness of its 2012 integrated report to the TBL interests and expectations of identified stakeholders. Finally, conclusions are drawn in Section 5.

The Changing Focus of Corporate Governance

Corporate governance is increasingly being recognised as a system that manages the relationship between the organization and its various stakeholders (Van der Laan Smith, Adhikari & Tondkar, 2005). Based on

this, an organization must be accountable towards an inclusive group of stakeholders who “can affect and is affected” by its activities (Freeman, 1984, p. 1), instead of only a narrow group of stakeholders with a financial interest in the organization (also see Greenwood, 2004; Stiglitz, 2009; Enderle, 2004; Eccles & Krzus, 2010; KPMG, 2010). Stakeholder engagement should not only be incorporated into an organization’s governance, but also its decision-making processes, strategy development and operations management (AccountAbility, 2011).

Within the South African context, companies listed on the Johannesburg Stock Exchange (JSE) are required to comply with the third King Code of Governance (King III).

Based on King III’s ‘stakeholder-inclusive’ approach to corporate governance, the board of an organization must make decisions in the best interest of the organization, while also considering “the legitimate interests and expectations of stakeholders” (IoDSA, 2009, pp. 4, 11). In this context, stakeholders are defined as “a group affected by and affecting the company’s operations” (IoDSA, 2009, pp. 4, 11, 60).

The “legitimate interests and expectations of stakeholders” are widely accepted as referring to the three value components of sustainability, namely economic, social and environmental, also referred to as the TBL (Elkington, 1998). King III views an organization as a corporate citizen with the responsibility to take cognisance of the TBL impacts of its operations both today as well as in the long run (IoDSA, 2009).

Furthermore, a commitment to sustainability requires improved organizational governance, stakeholder engagement and accountability, as well as organizational transparency. All of these are often incorporated into annual sustainability reports and/or integrated reports (Henriques, 2007; Gray & Milne, 2004).

The International Integrated Reporting Council (IIRC) (2011, p. 13) has stipulated five guiding principles for integrated reporting:

- i. The report should “provide insight into the organization’s strategic objectives” and how these create and sustain short, medium and long-term value in respect of the resources and stakeholder relationships on which the organization depends.
- ii. The report must reflect the interconnectivity of the organization’s business model, external factors that affect the organization, and the resources and stakeholder relationships on which the organization depends.

- iii. In order to help users to assess the opportunities and uncertainties that the organization faces, the report should be future-orientated.
- iv. The report should provide insight into an organization's stakeholder relationships, stakeholder interests and expectations as well as the organization's response.
- v. The report should reflect on the organization's ability to create and sustain value in the short, medium and long term

The Journey From Financial to Integrated Reporting and the Role of Stakeholder Management

Increasing pressure for reporting to reflect an organization's overall TBL performance has incentivised organizations to integrate sustainability reporting with annual shareholder reports (Weybrecht, 2010; GRI, 2011; International Corporate Governance Network, 2008). The Global Reporting Initiative's (GRI) framework is the most widely used guideline for sustainability reporting (Epstein, 2008).

In order for investors to understand the societal value instead of only the book value of the organization, reporting should reflect the organization's integrated sustainability performance. This can only be achieved through integrated reporting (IoDSA, 2009). Integrated reporting refers to the process that enables an organization to understand stakeholder expectations, societal pressures as well as environmental risks and challenges, in order to adapt organizational strategies accordingly (Rea, 2011).

To derive real benefit from this type of reporting, companies must expand stakeholder relationships beyond their traditional transactional relationships (Miller Perkins, 2010; Nessing, 2010). This is where effective stakeholder management fits in. In order to achieve its strategic objectives, an organization should assess and prioritise stakeholders' interests and expectations, and then respond to these in an engaging way (Grant, 1991).

Freeman (1984) suggests that an organization's stakeholder management capability can be analysed at three levels:

- i. Identify stakeholders as well as their interests in, and expectations of, an organization (the rational level of stakeholder management)
- ii. Engage with stakeholders (the transactional level of stakeholder management). This level of analysis provides insight into the organization's style of response to stakeholder concerns, also referred to as the "strategic posture" of an organization (Roberts, 1992). Freeman, Harrison and Wicks (2007) identify four possible strategic postures (*see Table 1*).
- iii. Create processes and capabilities to manage stakeholder interests (the process level of stakeholder management). Organizations must design and implement processes that will support stakeholder management (AccountAbility, 2011, p. 14).

Table 1: STRATEGIC POSTURES BASED ON AN ORGANIZATION'S STAKEHOLDER RESPONSE STRATEGIES

Strategic Posture	Implementation
1. Ignore the stakeholder	• The organisation does not interact with stakeholders. • The organisation does not allocate resources to deal with current or future stakeholders.
2. The public relations approach	• The organisation has a public relations department, which interacts with stakeholders. • Engagement with stakeholders is managed through communication programmes. • Communication is one-way, with the organisation telling 'its story'. • The focus is often to enhance the image of the organisation.
3. Implicit negotiations	• An organisation tries to anticipate stakeholder interests in products, services and initiatives, and formulate its strategies accordingly.
4. Engagement, dialogue and negotiations	• Communication is two-way, and the organisation has created multiple communication channels.

Source: Freeman et al., 2007.

The AA1000 stakeholder engagement standard provides the following five-step process for implementing stakeholder management (Beckett & Jonker, 2002):

Table 2: THE FIVE-STEP PROCESS FOR IMPLEMENTING STAKEHOLDER MANAGEMENT THROUGH ENGAGEMENT

Strategic Posture	Implementation
1. Planning	• Establish commitment and governance procedures. • Identify stakeholders. • Define and review current mission and values.
2. Accounting	• Identify issues through engagement with stakeholders. • Determine process scope along with stakeholders. • Identify indicators through stakeholder engagement.
3. Collecting information	• Collect information about performance in respect of the indicators identified. • Analyse information, set targets and develop improvement plans (reflecting values and using stakeholders to assist in revision).
4. Auditing and reporting	• Prepare reports explaining the process, targets and measures, and including comparative information from the past as well as benchmark-able information, where appropriate. • Audit reports using external process. • Communicate report and obtain feedback.
5. Embedding	• Establish and embed systems to create ongoing performance improvement in line with values.

Source: Freeman et al., 2007.

Understanding Stakeholder Management within Eskom

Introduction

An organization operates across three environments, namely the organizational, transactional and contextual environments (Hichert, 2011). Within each of these environments, there are stakeholders who affect and are affected by the organization. In the organizational environment, the organization has control over the internal processes, structures and functions of stakeholders (Hichert, 2011). Stakeholders within this environment may include management and employees (Freeman, 1984). In the transactional environment, the organization both influences and is influenced by stakeholders over whom it has no direct control (Emery & Trist, 1965; Hichert, 2011). Stakeholders within this environment may include customers, suppliers, shareholders, lenders and local communities (Freeman et al., 2007). Finally, the stakeholders in the contextual environment affect the organization, although the organization has little or no influence over the stakeholders. Here, stakeholders fulfil the role of 'referees', determining the rules of the game. In order to remain an effective player, an organization needs to adapt to this environment (Emery & Trist, 1965). Stakeholders within this environment may include competitors, the media, government, regulators, non-governmental organizations (NGOs) and industry experts (Freeman *et al.*, 2007).

At the rational level of stakeholder analysis, an organization's stakeholders can be grouped and plotted on a stakeholder map (Freeman, 1984). Stakeholder maps are tailored for various organizations based on the organization's specific purpose and function, and in some instances, stakeholders could fulfil multiple roles (Freeman *et al.*, 2007).

Rational Level: Who Are Eskom's Stakeholders and What Are Their TBL Interests/Expectations?

Stakeholders within Eskom's contextual environment: The fact that Eskom generates 95 per cent of electricity used in South Africa, and owns and operates South African power transmission grids, positions Eskom as a monopolistic electricity provider (Chamber of Mines, 2009, Creamer, 2010; Styan, 2011). This, combined with the fact that Eskom is one of the single largest contributors (direct and indirect) to South Africa's gross domestic product (GDP), makes the utility a critical role player within government's plan for economic development. Access to electricity is seen as a key enabler for social and economic growth and development (Inglesi-Lotz & Blignaut, 2011).

The electricity sector is regulated by the National Energy Regulator of South Africa (NERSA), which determines electricity prices/tariffs, regulates electricity imports and exports, and issues licenses for the generation, transmission, and distribution of electricity (Eskom, 2011). Policy oversight of this sector is the responsibility of the Department of Energy (DoE) (Tyler, 2009). The DoE is responsible for administering laws and regulations that govern, inter alia, renewable energy targets, diversification of energy sources, feed-in tariffs to allow independent power producers (IPPs) to sell generated hydro, wind, landfill gas and solar power to Eskom, the issuing of licenses, safety standards, and practices within the nuclear sector (DoE, 2013a; 2013b; Kiratu, 2010).

As a state-owned enterprise, the same legislative frameworks applicable to South African corporate entities apply to Eskom as well (RSA, 2001). These legislative frameworks include the National Environmental Management Act (RSA, 1998a), in terms of which the Department of Environmental Affairs requires an environmental impact assessment (EIA) for the construction and upgrading of facilities for commercial electricity generation and supply (RSA, 2010a; RSA, 2010b). The Department of Environmental Affairs is also responsible for the Minimum Emission Standards as part of the Air Quality Act (RSA, 2004). Subsequently, Eskom has installed many retrofits of abatement technologies to comply with these standards (Eskom, 2011). In terms of the National Water Act (RSA, 1998b), Eskom has to acquire a license from the Department of Water Affairs for hydro-energy projects and has to implement responsible water management practices (Sparks, 2006). Finally, the Companies Act (RSA, 2008), as administered by the Department of Trade and Industry (dti), provides guidance on the liability and conduct of the board of directors, management of shareholders, financial reporting, and enhanced accountability and transparency (BDO, 2008).

The contextual environment also includes ‘stake-watchers’, such as the media, industry experts, academia, and special interest groups such as activists and NGOs. Although these stakeholders are independent of Eskom, they greatly influence public opinion about the organization (Fassin, 2012; Clarkson, 1995; Frooman, 1999). Due to Eskom’s environmental impact, ‘stake-watchers’ include environmental NGOs such as Greenpeace South Africa, the Worldwide Fund for Nature (WWF), groundWork and Earthlife Africa (Alfreds, 2012; Hedley, 2012). Activists, unions, consumer groups, industry experts and industry representative bodies include the Congress of South African Trade Unions (Cosatu), the South African Municipal Workers’ Union (Samwu), the National Consumer Forum, the Chamber

of Mines, the South African Renewable Energy Council (SAREC) and the South African agricultural trade association, Agri SA. These groups are concerned that, for example, proposed price hikes will increase job losses, poverty and inequality in South Africa (De Wet, 2012; Ensor & Maoto, 2012, Njobeni, 2012, NERSA 2013).

Eskom's transactional and organizational environments: In 2002, Eskom was converted into a public company, with the Department of Public Enterprise (DPE) as its sole shareholder and the Minister of Public Enterprise as its shareholder representative. The DPE has oversight responsibility in terms of Eskom's governance and statutory compliance. The shareholder compact that governs the relationship between the DPE and Eskom consists of strategic, financial, technical and other key performance indicators and reporting requirements, against which the DPE measures Eskom's performance. These key performance indicators are determined in line with the Public Finance Management Act (PFMA) (RSA, 1999; IDASA, 2010; World Finance, 2013). The DPE also facilitates Eskom's interaction with National Treasury in requesting loans and guarantees (RSA, 1999). Further financing is obtained through the issuance of debt in the domestic and international capital markets (Eskom, 2013a).

In order to understand Eskom's organizational and transactional environments, the utility's operations and functions can be illustrated using the following value chain (*see Figure 1*):

Figure 1: ESKOM'S VALUE CHAIN



Source: Eskom, 2011; Eskom, 2012

Eskom uses coal, nuclear, hydro-electric, wind, open-cycle gas-turbine (OCGT) and pumped storage schemes as primary energy sources for electricity generation (Eskom, 2013b). The majority (around 88 per cent) of electricity is generated from coal, as South Africa's abundant supply of coal makes it a relatively inexpensive and reliable energy source. Around 55 per cent of all coal mined in South Africa is used for electricity generation (Dutkiewicz, 1994; Moodley, 2006; Kenny, 2006; IDASA, 2010), making Eskom a large customer of privately owned mining companies such as Anglo American, Exxaro and BHP Billiton (Eskom, 2011).

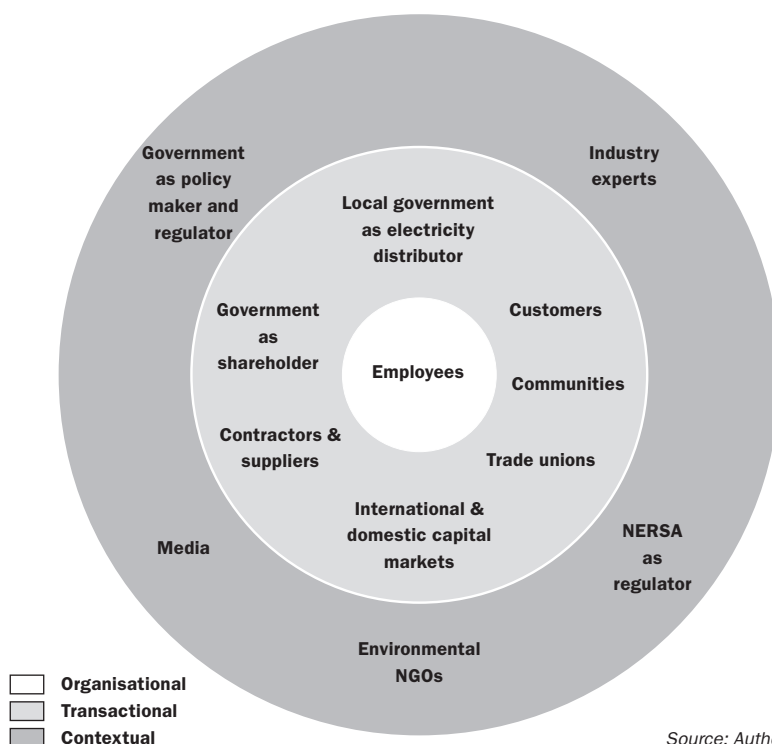
The uranium fuel used for electricity generation at Eskom's nuclear power station is imported, as this is more economical than local enrichment (Kenny, 2006). Eskom also operates 'peaking stations' in the form of four OGCTs, six hydro-electric stations, two pumped storage schemes and one wind energy station (Creamer Media, 2010). In addition, Eskom purchases electricity from local authorities such as municipal generators and IPPs, and imports electricity from a number of neighbouring countries (IDASA, 2010; Newbery & Eberhard; 2008, Kenny, 2006). The utility directly employs around 41 800 people, the majority of whom are unionised and represented by the National Union of Mineworkers (NUM) (Styan, 2011; Eskom, 2011; Davies, 2008).

Based on electricity consumption per sector, the largest proportion of electricity is consumed by the industrial sector (42 per cent), followed by the residential (17 per cent) and mining sectors (15 per cent), and commercial energy exported to Mozambique, Botswana, Namibia, Lesotho and Zambia (Eskom, 2011; Winkler, 2006). The predominant electricity consumers are 36 large industrial players organised as the Energy Intensive User Group (EIUG), who collectively consume some 40 per cent of all electricity sold in South Africa (IDASA, 2010).

Electricity is distributed either directly to customers by Eskom, or indirectly through 187 municipalities, who add a mark-up when they sell the energy on to consumers. Electricity sales are a critical source of revenue for some municipalities (IDASA, 2010, Creamer Media, 2010).

Eskom also assumes responsibility for the construction of new capacity for electricity generation and distribution. The build programme has a positive impact on skills training, employment and infrastructure provision for local communities and contractors. Simultaneously, however, expansion also introduces issues of displacement, health and safety, which need to be mitigated in communities. The expansion programme is also challenged due to the scarcity of capital (Eskom, 2011). Government is already a major equity investor in Eskom. To complete its new build programme, Eskom has to seek further funding from overseas capital markets as well as greater margins generated through tariff hikes (Kiratu, 2010).

Based on this analysis, stakeholders may be grouped and mapped as follows in the contextual, transactional and organizational environments (see *Figure 2*):

Figure 2: **ESKOM'S STAKEHOLDER GROUPS**

Source: Author's own.

Table 3 indicates the TBL interests and expectations of Eskom's identified stakeholder groups. The table also indicates how the integrated report responds to these interests and expectations, i.e. how responsive Eskom is in disclosing challenges associated with these interests and expectations, as well as how current and future initiatives of Eskom meet these interests and expectations.

Table 3: THE TBL INTERESTS AND EXPECTATIONS OF STAKEHOLDERS AND HOW THEY ARE ADDRESSED IN ESKOM'S 2012 INTEGRATED REPORT

Stakeholders		Interests and Expectations		
		Economic	Social	Environmental
Organisational	Employees	Fair remuneration¹ ●	- Skills developments² ▲●● - Safe working environment² ▲●● - Job security³	Energy-efficiency projects within the organisation²
	Government as shareholders	- Sustainable electricity supply⁴ ▲●● - Timeous completion of capacity expansion programme⁴ ▲●● - Securing funding for the capital expansion programme⁴ ▲●● - Achieve and maintain financial sustainability⁵ ▲●● - Transparency around economic impact³ ● - Assurance mechanisms and risk management ●	- Implementation of good governance practices⁴ ● - Transparency around social impact³ ●	- Managing operations in a way that minimises the impact on the environment⁴ ▲●● - Transparency around social impact³ ● - Assurance mechanisms and risk management ●
Transactional	International & domestic capital markets	Good credit rating ▲●●		
	Customers	- Affordable, nondiscriminatory, transparent tariffs⁶ ▲●● - Sustainable electricity supply⁹ ▲●●	Satisfactory customer service³ ●	
	Trade unions	Affordable electricity tariffs⁹ ▲●●		
	Suppliers & contractors	Fair payment for services and products¹⁰ ●	- Safe working environment² ▲●● - Skills development² ▲●●	
	Local government as electricity distributor			
	Communities	- Affordable, nondiscriminatory, transparent tariffs⁶ ▲●● - Employment² ● - Sustainable electricity supply⁹ ▲●●	- Investment in infrastructure² ▲●● - Safe and healthy living environment² ●	Minimum harm to the environment² ▲●●
Contextual	Industry experts	Transparency around economic impact³ ●	Transparency around social impact³ ●	Transparency around environmental impact³ ●
	Environmental NGOs			- Compliance with environmental legislation⁶ ▲●● - Reduced reliance on coal-fired power plants¹ ●
	NERSA as regulator	- Securing sustainable electricity supply⁹ ▲●● - Securing electricity tariffs that are affordable for Eskom's customers⁸ ▲		
	Government	- Drive economic growth by advancing electrification of South Africa⁴ ▲●● - Creating employment¹² - Achieve and maintain financial sustainability⁵ ▲●●	- Uplift local and rural communities in which Eskom operates^{4,12} ▲●● - Skill development - Transformation – BBBEE¹² - Universal access to electricity¹⁵ ▲●●	- Environmentally sustainable production and transport of primary energy for electricity generation⁵ ▲●● - Diversification of primary energy mix¹⁴ ● - Compliance with environmental legislation¹³ ▲●●
	Media	Transparency around economic impact³ ●	Transparency around social impact³ ●	Transparency around environmental impact³ ●
		▲ Report discloses challenges in meeting this expectation/interest	● Report discloses initiative already in place to meet this expectation/interest	● Report discloses further initiatives to meet this expectation/interest

1. Styan, 2011; 2. Eskom, 2011; 3. Freeman et al, 2007; 4. Department of Public Enterprise, 2012; 5. Department of Minerals and Energy, 2008; 6. Alfreds, 2012; 7. Hedley, 2012; 8. Geldard, personal communication, 8 March 2013; 9. Anderson, 2013; 10. Njobeni, 2012; 11. RSA, 2003; 12. NPC, 2011; 13. IodSA, 2009; 14. Department of Energy, 2011; 15. Sapa, 2012; 16. Inglesi-Lotz & Blynnaut, 2011; 17. Kirutu, 2010

Transactional Level: How Does Eskom respond to Stakeholders through its 2012 Integrated Report?

In the development of its 2012 integrated report, Eskom embarked on two initiatives to ensure improvement on its 2011 report. The first initiative was to conduct a 'gap analysis' in collaboration with an independent auditing team in order to identify areas for improvement (Accountancy South Africa, 2012; Jameson, personal communication, 10 December 2012). The second initiative was to participate in the IIRC's pilot programme for the development of an integrated reporting framework. Therefore, the report by and large conforms to the guiding principles set out by the IIRC, as well as considerations stipulated in King III (Accountancy South Africa, 2012; Jameson, personal communication, 10 December 2012; Eskom, 2012). The aim of the report is to demonstrate Eskom's progress in achieving its purpose and strategic objectives, as well as to highlight the challenges faced, and ways of overcoming them. The report aims to indicate Eskom's commercial value as well as the "overall value added to the lives of the public" (Eskom, 2012, p. 12).

In its integrated report, Eskom identifies the following stakeholder groups: (i) employees and unions; (ii) government, Parliament and regulators; (iii) lenders, analysts and investors, (iv) industry experts, academia and the media; (v) business groups, civil society and NGOs, (vi) suppliers and contractors, and (vii) customers (Eskom, 2012). These stakeholders correspond with the stakeholders identified in Figure 4.2. The report does not specify how these stakeholders were identified, grouped or prioritised, nor does it elaborate on the stakeholder subcategories within each group, except for government, where stakeholders are specified as the DPE, DoE, Department of Water Affairs, National Treasury and local government (Eskom, 2012). The report indicates the methods of stakeholder interaction used by Eskom, namely forums, committees, e-mail correspondence, roadshows, websites, workshops, quarterly briefings, information in newspapers, and one-on-one meetings. Annual reports are only indicated as a method of interaction with the executive arm of government, Parliament, regulators, lenders, analysts and investor stakeholder groups (Eskom, 2012). As the South African government is Eskom's primary shareholder, this is in line with the IIRC's guidelines for the target audience of an integrated report (IIRC, 2011).

The report furthermore links Eskom's eight strategic objectives to issues identified in consultation with stakeholders, operations within Eskom's value chain, and the performance indicators attached to the strategic objectives (Eskom, 2012).

The issues addressed in the integrated report can be compared to the stakeholders' TBL interests and expectations, as indicated in Table 4.1 above, to ascertain whether the report sufficiently discloses the challenges that Eskom is experiencing, as well as current and future initiatives to address these. On balance, it can be concluded that Eskom's integrated report is responsive to stakeholder interests and expectations, and that the utility therefore displays a strategic posture of engagement, dialogue and negotiations towards its stakeholders.

Process Level: How Does Eskom manage its Stakeholders and Integrated Reporting?

For the development of Eskom's 2012 integrated report, a governance structure was established consisting of an Integrated Report Steering Committee (IRSC) and five supporting working groups. The working groups were those for stakeholder management, sustainability auditing, financial auditing, enterprise performance management, and integrated reporting (Accountancy South Africa, 2012; IIRC, 2011; Jameson, personal communication, 10 December 2012).

The working groups determined the content of the integrated report based on the eight strategic objectives in Eskom's six-year corporate plan. This was done through stakeholder consultation and by focusing on the components of the value chain. The aim of Eskom's corporate plan is to "provide South Africa with secure, affordable, accessible and cleaner power" now and in the future, in order to "grow the economy and improve the quality of life for South Africans". This corresponds with the mandate formulated by Eskom's main shareholder, the DPE (Eskom, 2012, pp. 12, 14).

Eskom's purpose is "to provide sustainable electricity solutions to grow the economy and improve the quality of life of people" (Eskom, 2012, p. 26). Eskom's five strategic objectives have been aligned with stakeholder issues, and each objective has key performance measures and targets attached to it. A new organizational structure has also been implemented in order to provide the right platform for the implementation of the utility's six-year corporate plan (Eskom, 2012).

Stakeholder management is the responsibility of all divisions within Eskom, with coordination provided by the stakeholder management department. After stakeholders have been identified and prioritised, they are managed by the relevant and most appropriate departments and personnel – even though the focus remains a cross-cutting one. As an example, Eskom's industrial stakeholders are managed by customer

executives; Eskom's engagement with its main shareholder (the DPE) is managed by the Chairman's office, and environmental NGOs are managed by the sustainability department (Rambharos, personal communication, 10 December 2012).

Eskom's integrated reporting approach corresponds with the five steps proposed by Beckett and Jonker (2002) for implementing stakeholder management (refer *Table 3*).

Eskom's commitment to the implementation and reporting of good corporate governance practices was acknowledged when Ernst and Young awarded Eskom's 2011 integrated report second place in the Corporate Sustainability Reporting Awards (World Finance, 2013).

Conclusion

Eskom's integrated report does not explicitly map stakeholders, nor does it systematically name the stakeholders' TBL interests and expectations (i.e. at the rational level of analysis). However, nearly all the identifiable TBL interests and expectations of stakeholders are addressed in Eskom's integrated report (i.e. at the transactional level of analysis). That said, the report could be more forward-looking by placing greater emphasis on disclosing future initiatives to meet stakeholder expectations.

At a transactional level, it can be concluded that Eskom displays a strategic posture of engagement, dialogue and negotiations towards its stakeholders. This is based on the disclosure of numerous stakeholder engagement processes in the integrated report. In addition, it can be observed from Eskom's statement of purpose, that the utility focuses on distributing value "to the plurality of stakeholders", which can only be achieved through "cooperation and support of ... stakeholders" (Minoja, 2012, p. 36). Eskom's purpose and its commitment to comply with King III requirements underscore the utility's intent to follow a stakeholder-inclusive approach.

At a process level, Eskom has implemented an integrated reporting governance structure that allows for the integration of stakeholder engagement. Furthermore, Eskom has developed and implemented an organizational structure to ensure that its strategic objectives are being met in a way that considers stakeholders' TBL interests and expectations. Eskom's process of stakeholder management and disclosure through integrated reporting appears to be similar to the five-step approach for stakeholder engagement as stipulated by the AA1000 stakeholder engagement standard (refer *Table 3*).

Based on this analysis, Eskom displays a strategic posture of engagement, dialogue and negotiations towards its stakeholders, and the utility's integrated reporting process follows the five steps of stakeholder management proposed by Beckett and Jonker (2002). It is therefore concluded that, by and large, Eskom follows a 'stakeholder-inclusive' approach to corporate governance.

Discussion Questions

- i. Describe the value chain of an organization of your choice, and based on the value chain, identify and map stakeholder groups within the organizational, transactional and contextual environments.
- ii. Identify the TBL interests and expectations of these stakeholder groups.
- iii. Using the organization's latest integrated report, what stakeholder groups are identified? Do these stakeholder groups correspond with the stakeholder groups you identified?
- iv. Which of the TBL interests and expectations are addressed in the integrated report? Does the integrated report indicate the organization's challenges in meeting these interests/expectations and the current and planned initiatives to address these interests/expectations?
- v. What does the integrated report disclose about stakeholder interaction, and which methods are used to engage with stakeholders?
- vi. What does the integrated report disclose about stakeholder management processes within the organization? Do these processes correspond with the five-step process for stakeholder management as stipulated by the AA1000 standard?
- vii. Based on the above analysis, what strategic postures does the organization display towards the stakeholder groups identified?
- viii. Do you think that this organization has effectively implemented the three levels (i.e. rational, process and transactional) of stakeholder management? Substantiate your answer.

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BIOGRAPHY

Christelle Marais is a strategy consultant at a global management consulting firm, where her key areas of interest are sustainability and corporate governance. She obtained her BSc in Biochemistry, Microbiology and Food Science from Stellenbosch University in 2002. In fulfilment of her subsequent master's degree in Business Administration at the University of Stellenbosch Business School (USB), her research report focused on corporate governance, stakeholder management and integrated reporting within South Africa's state-owned electricity utility. While working in the fresh-fruit export industry within South Africa, Christelle gained extensive experience in the field of sustainability.



Shaun Vorster is special adviser to the South African Minister of Tourism. He is also associated with the University of Stellenbosch Business School (USB) where he is a guest lecturer on the MBA course on "Business in Society". From 2004 to 2009, he served as special adviser to the South African Minister of Environmental Affairs and Tourism. In this capacity, he was actively engaged in international climate change and environmental governance negotiations. In 2012, Shaun completed a master's degree in Business Administration (MBA) cum laude at the USB. He received the PSG award for overall top MBA student. Shaun holds a doctorate (DPhil), MA (cum laude) and BA Honours (cum laude) degrees in Political Science.



Chapter 7

Does the Ban by Boy Scouts of America on Gays hurt Scouting?

Sunny Jeong

Abstract

The Boy Scouts of America (BSA) is one of the largest youth organizations in the United States, with 2.7 million youth members and over 1 million adult volunteers. BSA was once a symbol of American culture and now regarded as a “symbol of prejudice.” BSA has been sued because of its membership, leadership, and employment standards. Some of the lawsuits dealt with the BSA’s standards that require Scouts and Scouters to believe in God, those in leadership positions to not be openly homosexual, and the exclusion of girls from membership in some programs. The BSA contends that these policies are essential in its mission to instill in young people the values of the Scout Oath and Law. As a private organization, the Boy Scouts has the right to determine who can and cannot be a member. The Supreme Court determined in 2000 the organization does not have an obligation to let gays openly participate, although gays and lesbians have been quietly participating for decades. The policies have led to hugely divisive disputes and controversies. This case discusses recent challenges BSA faces on an issue of membership policies within a framework of decision-making procedures of nonprofit organizations.

Organization Background

Since its incorporation in 1910 under the law of the District of Columbia as part of the World Organization of the Scout Movement, more than 114 million American youth have been members. The traditional Scouting divisions are Cub Scouting for boys ages 7 to 10 years, Boy Scouting for boys ages 11 to 17 and Venturing for young men and women ages 14 to 20. The National Headquarters opened in New York City in 1911 and has been in Irving, Texas since 1979. Constitution and bylaws were adopted in 1916. In 2005, the BSA ranked as the twelfth-largest non-profit organization in the U.S., with total revenues of \$665.9 million. As of 2012, the Charity

Rating Guide & Watchdog Report listed Robert J. Mazzuca, Past Chief Scout Executive as having the fifth-highest compensation of any nonprofit chief in the United States, at \$1,136,942.

BSA changed the English form of Scout Oath by adding its third requirement, “To keep myself physically strong, mentally awake, and morally straight”-body, mind and spirit in 1911. Another two requirements are “1. To do my duty to God and my country, and to obey the Scout Law; 2. To help other people at all times. The third requirement of “morally straight” is often cited by opponents on inclusion of homosexual members.

Chartered Organization and Units

The Boy Scouts of America partners with community organizations, such as civic, faith-based, and educational organizations, fraternal groups, and other community associations. These organizations hold charters issued by the BSA and provide the Scouting program for their youth members. Each chartered organization provides the meeting place for BSA youth, oversees the volunteer leaders, and appoints a charged organization representative to coordinate all Scouting unit operations within the organization. The organization is considered the “owner” of its local program, much like a franchise. Each chartered organization may operate 3 or 4 Scouting “units.” A unit is a group of youth and adults which are collectively designated as a Cub Scout pack, Boy Scout troop, Varsity Scout team, or Venturing crew/Sea Scout ship. Over seventy percent of all units are chartered to faith-based organizations such as The Churches of Jesus Christ of Latter-day Saints, United Methodist Church, Catholic Church and Presbyterian Church. Units in any chartered organization create their own activities (such as monthly camping trips, outings, or service projects), and most meet weekly at the place of the chartered organization for youth to learn basic skill development and practice leadership in small groups known as dens and patrols.

Local councils with both paid Professional Scouters and volunteers support the chartered organization. The chartered organization appoints volunteers to lead units. The BSA National Council provides the leader training, inter-unit activities, camping programs, volunteer and professional support, and insurance coverage.

There are 283 local councils, with each council covering a geopolitical area that may vary from a single city to an entire state. The first local council charters were issued in 1913. Councils receive an annual charter from the National Council and are usually incorporated as a charitable organization.

The council level organization is similar to that of the National Council. The council executive board is headed by the council president and is made up of annually elected local community leaders. The board establishes the council program and carries out the resolutions, policies, and activities of the council. Board members serve without pay and some are volunteer Scouters working at the unit level. Youth members may be selected to the council executive board according to the council by-laws.

The National Council is the corporate membership of the Boy Scouts of America and consists of volunteer Scouters who meet annually. National Council members include volunteers who are elected National Officers and Executive Board members, regional presidents, the local council representatives, members at large, and honorary members. National Council elects a voluntary president who leads the BSA National Executive Board. The BSA National Executive Board governs the organization (77 members). Board members include regular elected members, regional presidents, and up to five appointed youth members. The National Executive Board has a number of standing committees that correspond to the professional staff organization of the National Council. The Chief Scout Executive is the board secretary and non-voting member who operate BSA's day-to-day operations.

Funding

The National Council is incorporated as a 501(c)(3) nonprofit organization and is funded from private donations, membership fees, corporate sponsorships, grants from foundations, scout supply sales and special events. In 2010, their top corporate sponsors were, in order, Intel, Emerson, Verizon, 3M, Bank of America, Wells Fargo, Pfizer, Valero, UPS, U.S. Bank, Eli Lilly, GE, and Monsanto.

Recent Membership Decline

Membership in Boy Scouts has declined by about a third since 1999. About 2.7 million people now participate in scouting nationwide, with more than 70% of troops affiliated with a church or religious groups. Regardless of the current issue concerning the ban on gay membership, The BSA has faced declining members every year and needs to find new ways to connect with young people.

BSA Membership Size

YOUTH MEMBERSHIP COMPARISON BETWEEN 1999 AND 2012

Year	Tiger Cubs, Cubs, Webelos	Boy Scouts, Varsity Scouts	Venturers	Total Traditional Scouting
1999	2,181,013	1,028,353	202,486	3,411,852
2012	1,528,421	910,163	219,453	2,658,794
Change (since 1999)	– 29.9%	– 11.5%	+ 8.4%	– 22.1%

Recent Debate on the Membership Policy of Sexual Orientation

The BAS’s official position is to “not grant membership to individuals who are openly or avowed homosexuals” as Scouts or adult Scout Leaders in its traditional Scouting programs. As early as 1980, the Boy Scouts of America have denied membership for openly homosexual individuals applying for adult leadership positions. In 1991 the BSA released a position statement expressing the organization’s official position, stating: “We believe that homosexual conduct is inconsistent with the requirement in the Scout Oath that a Scout be morally straight and in the Scout Law that a Scout be clean in word and deed, and that homosexuals do not provide a desirable role model for Scouts.” The BSA thus “believes that a known or avowed homosexual is not an appropriate role model of the Scout Oath and Law.”

During the 1980s and 1990s, several people attracted media attention when they sued the BSA, attempting to make them accept atheists as members and openly homosexual individuals in leadership positions. In 1981, Tim Curran, an openly homosexual former Scout, sued asking that he be accepted as an assistant Scoutmaster (see *Curran v. Mount Diablo Council*). In 1991, twin brothers William and Michael Randall, who had refused to recite the “duty to God” portion of the Cub Scout Promise and Boy Scout Oath, sued to be allowed to continue in the program (see *Randall v. Orange County Council* and *Welsh v. Boy Scouts of America*). In addition, there were several other lawsuits involving essentially the same issues. Ultimately, the courts ruled in favor of the Boy Scouts of America in each case.

Also, in *Boy Scouts of America v. Dale*, in 2000, the Supreme Court of the United States ruled that as a private organization, the BSA can set its own membership standards.

The BSA’s policies have been legally challenged but have not been found to constitute illegal discrimination; as a private organization in the United States the BSA has the right to freedom of association, as determined in the

court case. BSA does not have an obligation to let gays openly participate, although gays and lesbians have been quietly participating for decades. After the Dale decision, public opinion in some communities turned against the BSA; corporations, charities, and even some local governments criticized the policy, threatening to either cut off financial support or block the Boy Scouts from using public buildings for their meetings. While some segments of the public criticized the organization, other groups became more enthusiastic in their support of the Scouts.

Since the Dale decision, some Eagle Scouts (about 100) have returned their Eagle Scout badges to the BSA in protest. Some board members of BSA strongly believe it's time to discuss changes in its policy. Two of the 16 members of the board of directors announced their support on the policy change. Zach Wahls, the founder of Scouts for Equality opposes the ban and has accumulated almost 1.5 million signatures on various petitions in support of their position. Other organizations such as "Forgotten Scouts" and "The Inclusive Scouting Network "Scouting for All" promote an end to the membership biases. They work to convince groups to cease funding troops while this policy is in place. They succeeded in having several United Way groups remove funding, as well as having Intel end their \$700,000 annual support of local Troops.

In 2002, the National Executive Board of Boy Scouts of America reiterated its support for the policies and affirmed that "the Boy Scouts of America shall continue to follow its traditional values and standards of leadership". Membership has still been revoked in cases where an individual is found to be openly homosexual. In 2005, a high-level employee of BSA was fired by the National Council after the organization received a copy of his bill from a gay resort at which he had vacationed. In 2009, the mother and civil union partner of a Vermont Scout were prohibited from volunteering for his pack when it was learned they were gay. In 2012, Jennifer Tyrrell, an Ohio den leader, was dismissed by her local Boy Scout officials for being a lesbian. BSA reaffirmed its ban on gay scouts and leaders in every single case.

This policy of the BSA is more restrictive than other Scouting organizations throughout the world and other youth organizations within the United States. For example, homosexuals are not restricted from membership in Canada, UK, Germany or Sweden while American youth organizations such as the Girl Scouts of the USA accept gays and lesbians, and allows its members to substitute another word in place of "God" when reciting the Girl Scout Promise.

On July 17, 2012, BSA backed the current policy, the ban on gay membership after a two-year review by an 11-person committee. The organization's decision at that time was mainly due to the opinions of a "vast majority of parents" of Boy Scout members. However, with the increasing pressure on BSA to alter its policy, BSA has proposed that local scouting units should be allowed to decide membership rules for themselves. This decision has both political and economic implications for its governance.

Political Implications

Long-time Scouting supporters, parents and chartered organizations have expressed opposition to the existing gay ban policies in ways ranging from protests to forming organizations that advocate greater inclusiveness. Gay right groups including the Gay and Lesbian Alliance Against Defamation and other critics argue that Scouting should be open to all. Banning certain groups is obvious discrimination against basic human rights. Gay Americans ought to be able to participate in the Boy Scouts.

Eagle Scout filmmaker Steven Spielberg has been a long-time supporter of Scouting, depicting a young Indiana Jones as a Boy Scout in the 1989 film *Indiana Jones and the Last Crusade* and helping to create the Cinematography merit badge. Spielberg resigned from the BSA Advisory Council in 2001, saying, "it has deeply saddened me to see the Boy Scouts of America actively and publicly participating in discrimination."

A poll conducted between January 30 to February 4, 2013 by Quinnipiac University, found 55 percent of respondents supported opening up scouting to gay men and lesbians. Women, (61 percent to 27 percent), were more likely than men to favor dropping the ban. Among men, 49 percent approved ending the ban, compared with 39 percent opposed.

Although BSA consistently stands firmly with its gay ban policy, some board members and local councils represent different stances. Two BSA board members, Randall Stephenson (AT&T CEO) and James Turley (Ernst & Young CEO, on track to become president of the board in 2014), have publicly supported ending the ban. They intended "to continue to work from within the BSA Board to actively encourage dialogue and sustainable progress" in changing the policy.

Local councils in Scouting have a large amount of autonomy and many councils hold unofficial positions of "don't ask, don't tell" regarding sexual orientation. In 2001, the Central New Jersey Council signed a letter agreeing not to discriminate against homosexuals to ensure continued financial support from the United Way of America. The United Way

had ended financial support for the Great Trails Council after it refused to sign a nondiscrimination policy. The Boston Minuteman Council in Massachusetts approved a nondiscrimination bylaw in regards to sexual orientation while also clarifying that discussions of sexual orientation were not permitted in Scouting. However, after the Minuteman Council approved their nondiscrimination bylaw, they rejected the merit badge application of an openly homosexual individual whose membership in the BSA had previously been revoked in New Hampshire. The Minuteman Council asserted that “We will not accept anybody who has had his membership revoked by the national council.” The United Way ended financial support of the Minuteman Council as a result of the controversy. As a result of unit level nondiscrimination policies, charters were revoked from several Cub Scout packs in Oak Park, Illinois. In 2003 the Cradle of Liberty Council in Philadelphia approved a nondiscrimination policy, but the national council forced the local council to revoke the policy. National ruled that local councils may not deviate from the national policy of not granting membership to open or avowed homosexuals. In 2005 the Cradle of Liberty Council adopted another nondiscrimination policy, but in 2006 the city of Philadelphia began asking for a more clear-cut nondiscrimination policy. Due to the council’s refusal, the city ordered the council to pay fair-market rent for their offices in a landmark Philadelphia building where their annual rate was previously a dollar, resulting in the *Cradle of Liberty Council v. City of Philadelphia* lawsuit, that was ultimately decided in the Scouts favor and a Federal Court decision that the city had unfairly targeted the Scouts. Nine councils from large metropolitan centers requested the right to define their own membership policies. The proposal was taken to a national relationships committee of BSA.

On the other hand, conservative groups and politicians, and religious organizations have argued against changing the policy. They believe the policy change will dilute the Boy Scout message of morality and potentially destroy the organization, a point made by the conservative Family Research Council and 41 allied groups (including the American Family Association, American Values, Bott Radio Network, Catholic Family & Human Rights Institute, International Communion of Evangelical Churches, Liberty Counsel, Southern Baptist Ethics & Religious Liberty Commission, Patriot Voices, and a number of state family policy organizations) in a half-page ad in *USA Today* on Feb 4, 2013.

They argue that “every American who believes in freedom of thought and religious liberty should be alarmed by the attacks upon the Boy

Scouts, who have had core convictions about morality for 100 years,” the ad said. “Every Scout takes an oath to keep himself ‘morally straight.’” The ad emphasizes that, “To compromise moral principles under political and financial pressure would teach the boys cowardice, not courage.”

Some conservative politicians have also been very vocal. Former Republican presidential candidate Rick Santorum stated that the change could destroy scouting. Texas Gov. Rick Perry dismissed the idea of changing the century long tradition to the whims of “popular culture.” “Do not back off against the principles you’ve had for 100 years,” said Kelly Williamson, 52, a second-generation scout in the suburbs of Dallas. “Really, this is nothing against the gay community,” he added. “Have them form their own organization. It’s kind of ironic, gay scouts come in and saying, ‘We want you to change how you’ve done this for 100 years.’ ”

Since the founding of the BSA in 1910, the President of the United States has served as the organization’s honorary president during his term in office. In July 2001, President George W. Bush addressed the National Scout Jamboree and, although he did not directly discuss the controversies, reiterated his support for the organization. At the Jamboree, Bush commended the Scouts for upholding “values that build strong families, strong communities, and strong character” and said that the Scouts’ values “are the values of America. (By way of contrast, in 2012, both President Barack Obama and Republican presidential candidate Mitt Romney stated that they oppose the ban on gay Scouts.)

Churches sponsor 70 percent of scouting units and many church boy scout members will pull support from scouting if the change goes through. The Family Research Council and other conservative organizations raise such questions as:

“What happens when we go camping and there’s units that allow gays and homosexuals and there’s units that don’t, how are we going to keep them separated from those units and how are we going to instill in our kids Christian values and the biblical truth if that’s allowed in our program?” and “How will parents be able to entrust their children to the Boy Scouts if they trade the well-being of the boys for corporate dollars?”

The Church of Jesus Christ and the Latter Day Saints (the Mormon church), which has the largest numbers of participants at 12% of members and 25% of total donations, is also against this change.

Economic and Political Implications

After reaffirmation of the ban July 2012 scouting's financial support has taken a hit, with some corporate sponsors backing away.

Government Sponsorship

Private individuals and organizations have filed lawsuits to prevent governmental entities from granting what they see as preferential access. The BSA on the other hand has sued governmental entities for denying what it sees as equal access.

For example, the American Civil Liberties Union (ACLU) has taken legal action to stop governmental organizations from serving as the chartered organizations (sponsors) of Scouting units in violation of the establishment clause of the First Amendment. "The ACLU of Illinois charged that the Boy Scouts' policy violates the religious liberty of youth who wish to participate but do not wish to swear a religious oath, and that direct government sponsorship of such a program is religious discrimination." In response, the Department of Defense announced in 2004 that it would end direct sponsorship of Scouting units.

The BSA agreed in 2005 to transfer all charters it had issued to governmental entities to private entities. Previously, about 400 Scouting units had been sponsored by U.S. military bases and over 10,000 by other governmental entities, primarily public schools.

In response to these changes and litigation, the federal government passed laws mandating that BSA units be given equal access to local and state-level governmental resources. The Boy Scouts of America Equal Access Act, enacted in 2002, requires public elementary and secondary schools that receive U.S. Department of Education funding to provide BSA groups equal access to school facilities. The Support our Scouts Act of 2005 requires state and local governments that receive HUD funding to provide BSA groups equal access to governmental forums (lands, facilities, etc.). State and local governments still have flexibility regarding the provision of special access to the BSA.

Corporate Sponsorship

Some public entities and private institutions have ceased financial or other support of the BSA. About 50 of the 1,300 local United Ways, including those in Cleveland, Miami, Orlando, Philadelphia, San Francisco, and Seattle, have withdrawn all funding. The BSA has also lost all funding from several large corporations that had been regular donors, such as

Chase Manhattan Bank, Levi Strauss, Fleet Bank, CVS/pharmacy, and Pew Charitable Trusts. For example, Pew Charitable Trusts, which had consistently supported the BSA for over fifty years, decided to cancel a \$100,000 donation and cease future donations. A number of public entities (including the cities of Chicago, San Diego, Tempe, Buffalo Grove, Berkeley, and Santa Barbara, as well as the states of California, Illinois, and Connecticut) have canceled charitable donations (of money or preferential land access) that had historically been granted to the Scouts. On September 22, 2012, Intel, the BSA's largest corporate donor, officially withdrew its financial support from any troop that cannot sign a statement confirming that the troop does not discriminate based on creed or sexual orientation. In November 2012, the UPS Foundation, a philanthropic division of UPS, halted their financial donations, amounting to \$85,000 in 2011, to the BSA because of their discrimination based on sexual orientation. In 2012, Merck & Co. stopped their funding due to the policy excluding gays and lesbians.

Governance Implications of the Proposed Change in Policy

BSA's proposed policy change was released to the public in an unplanned manner. With media outlets reporting on January 28, 2013 that BSA was intending to reverse its previous ban on homosexuals for leadership and scouting. BSA confirmed its proposal is true and it would consider changing the policy. "The policy change under discussion would allow the religious, civic, or educational organizations that oversee and deliver Scouting to determine how to address this issue," Deron Smith, public relations director, said in the statement.

The process whereby this major new policy proposal became public raises significant issues for governance. Discussion and reflection as to its ramifications should have taken place in a quiet manner and behind closed doors free from the outside pressures that have buffeted scouting and away from public comment and scrutiny. Instead, Board members were besieged by the ferocious attention and frustrated that their decision making process had been hijacked. Hugely divisive public debate has arisen. About 17,000 e-mails flooded the BSA's in-box in just five minutes after the media's coverage of the new BSA's policy.

On the other hand, it is noteworthy when the Boy Scouts announced in late January, 2013 it was going to reassess the ban and have the board vote on the policy it came to a surprise to its own members. Transparency is critical for non-profit organization's governance. An organization needs to clearly state how it is gathering and using feedback from its stakeholders

in making the decision. The Boy Scouts never announced how it was going to gather feedback from members, alums, funders and other stakeholders before the board was to vote. The Boy Scouts Facebook page was the only means for gathering feedback, and even that wasn't intentional.

Regardless how, and if, the Boy Scouts vote in May on its membership ban, the national organization needs to reassess its whole decision-making and communications process on this matter to ensure future decisions reflect the Scout Law, including being trustworthy.

BSA's Future Direction

The board was expected to vote at its National Executive Board meeting, Feb 6, 2013 on a new proposal. However, it postponed its decisions until May at organization's National Annual Meeting by saying it needs more time to get comment on the issue from its members. 1400 members of the group's national council will attend and vote this coming May 22-24 in Grapevine, Texas. The National Key 3-Wayne Perry, Chief Scout Executive Wayne Brock, and National Commissioner Tico Perez - have launched what they call a "family discussion" that's set to take place over the next three months.. The result of this "family discussion" is expected to be a resolution presented in May at the National Annual Meeting (NAM) to the voting members of the national council, a group consisting of volunteers from every local BSA council who have already been named as voting delegates. Much like the Electoral College, the number of delegates is based on a council's membership; larger councils get more voting delegates. According to the BSA, the goal of three month review is to:

- Ensure a channel for every voice to have an opportunity to be heard
- Receive feedback from the field
- Educate Scouting's members
- Define core values
- Identify members' concerns

This process was only set in this particular instance but it would be beneficial to create a standard part of governance based on this case.

Here's a timeline of what to expect over the next three months:

- **Planning (Feb. 6-28):** The BSA defines desired process and intended outcomes.
- **Listening (March 1-April 5):** BSA committees engage key stakeholders for input and the development of assessments.

- **Evaluating (April 5-17):** BSA officers review committee reports and prepare a resolution that the National Council voting members will act on at the National Annual Meeting in Grapevine, Texas.
- **Educating (April 18-May 24):** The reports and the resolution are shared with the voting members of the national council and the Scouting family.
- **Deciding (May 22-24):** The BSA conducts on-site information sessions for voting members at the National Annual Meeting, and a vote takes place.
- **Implementing (May 24 and on):** Based on the results of the vote, the BSA will determine and implement the next steps for the organization.

From February to May of its annual meeting, three-month debate became very public even though BSA never intended it. This creates pressure for BSA to declare where they stand. Whichever decision made by BSA should serve best for interests of its own members not swayed by external organizations.

Discussion Questions:

1. Nonprofit should position themselves to serve its organizational missions and the best interest of its members and stakeholders. BSA is merely presenting the facts and helping to empower stakeholders to make an informed decision and do what's best for the BSA. What should have been the best way to bring this issue to the attention of its stakeholders for better decision making process?
2. Examine the concerns of youth, chartered organizations, and parents. Whose interest should be considered most for the benefit of the organization?
3. What are potential impacts if this decision is made one way or the other considering financial, fundraising, and legal concerns? Based on this analysis, which decision should be more beneficial?
4. Compare your answer of Q2 and Q3. Discuss and reflect if your answer is not consistent.
5. Allowing and receiving public opinions on its organizational governance and decision making will be harmful or beneficial. Will this open discussion be necessary for many national scale non for profit organizations? Outpouring feedback from the American public may not necessarily be beneficial for an organization with its own mission and for its members whose interests they need to serve. Discuss pros and cons of media coverage in terms of a decision-making procedure.

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BIOGRAPHY

Sunny Jeong joined the faculty at the Business Department of the Wittenberg University in 2012. Before Wittenberg, she worked at the University of Illinois at Urbana-Champaign. She received her Ph.D. and M.S. from the University of Illinois at Urbana-Champaign. Her teaching area is international business, global leadership, and social entrepreneurship. Her research interests are non-profit organizations (social enterprises)' social network strategies, religious roles in entrepreneurship, service learning, and social justice.



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Chapter 8

Corporate Governance implemented: Using IT to set up Robust and Measurable Governance Structures

Klaus Jakisch

Abstract

There is no single truth about corporate strategy; however, there is a single truth when it comes to successfully implementing one. “If you cannot measure it, you cannot manage it.” (Kaplan, 1996)

Corporate strategy needs to be governed and implementation needs to be measured, otherwise achievements of associated objectives cannot be proven.

Corporate governance provides a legal and a factual framework for steering and controlling a corporate environment and for supporting its strategy. A lot of factors influence corporate governance; legal and regulatory industry requirements, internal and external stakeholders and competition are amongst them.

Industry accepted frameworks allow corporations to apply good/best practices in setting up solid governance structures, for example, COSO, COBIT. Some of these frameworks focus more on the business aspects; others concentrate on IT. In order to measure the effectiveness of the implementation and to periodically check performance indicators, IT departments are often involved in this process.

This paper advocates that separate IT governance is needed in parallel to corporate governance. It also advises on combinations of frameworks that should be used to have a practical and operable solution to support corporate strategy.

Introduction

Corporate governance has gained progressively more attention over the last years. Recent scandals of corrupt corporations, erroneous published company statistics as well as globalization and liberalization of markets has forced (exchange listed) corporations to put more effort on governance issues.

Corporate governance provides a legal and a factual framework for steering and controlling a corporate environment. Linked to an internal control system, it manages performance and compliance. Using management systems that are IT supported and under the control of IT departments, these systems must be able to extract information and produce/compile reports that are meaningful to business management. A clear interdependency between business and IT is the result.

The IT department is traditionally a supporter and execution mechanism for business direction, however, it has moved in various companies to a more prominent role, an enabler role. It is interrelated with corporate functions and must be integrated in corporate governance to reach its goals and to make results measurable.

This paper seeks to answer the question: If IT governance is needed in parallel to corporate governance? And if yes, how it can support corporate's strategic goals?

IT Governance within Corporate Governance

IT governance is a subset of corporate governance. In contrast to corporate governance established in the 1930s, IT governance started to appear in publications in 1993. It still struggles to get the attention that it needs. A strong indication for this is that a clear definition for IT governance is still missing. In the following discussion, the following definition will be used:

“IT governance is the responsibility of the board of directors and executive management. It is an integral part of enterprise governance and consists of the leadership and organizational structures and processes that ensure that the organization's IT sustains and extends the organization's strategies and objectives.” ³

The relationship between the two disciplines

In a survey facilitated 2009 by PricewaterhouseCoopers (PwC) Belgium on behalf of the IT Governance Institute, 27% of interviewed companies stated that IT governance is distinct from enterprise governance ⁴, a result that does not surprise and still leaves a lot of room for improvement. Ultimately both disciplines follow the same generic objectives - maximizing company's value and minimizing risks – however, their language and objectives may be different. As a result it may be difficult for the different company units/departments to follow these common goals without alignment.

³ [ITGove03], page 10

⁴ see [ITGove09], page 22

In order to reach common objectives, the main question remains, who manages governance topics such as value, risk and compliance?

Furthermore, the maturity, significance, and the role (supporter vs. enabler) that the IT department holds play an important role if and how these two disciplines interact. It also has to be considered if IT or IT related services are the products of the company, or if IT services are just a support mechanism in executing the main business purpose.

De Haes and Van Grembergen state that “relational mechanisms are very important. It is possible that an organization has all the IT governance structures and processes in place, but it does not work out because business and IT do not understand each other and/or are not working together. Or, it may be that there is little business awareness on the part of IT or little IT appreciation from the business. So, to reach effective IT governance, two-way communication and a good participation/collaboration relationship between the business and IT people are needed.”⁵

Instead of isolating the disciplines from each other, “IT governance can be integrated within a wider Enterprise governance approach, and support the increasing legal and regulatory requirements of corporate governance.”⁶ The combined approach would create credibility at the stakeholders and the automation of processes would lower the probability that some parts of the complex legal and regulatory area are overlooked.

Who are the main players?

Both areas – business and IT - should involve various internal stakeholders in IT governance, however the Board of Directors must be involved and should actively involve itself in the decision making groups as ultimately it is the Board’s responsibility. Besides the Board, typical internal stakeholders are business executives, the CEO, CIO (Chief Information Officer), IT Architecture Review Board, Technology Council, IT steering committee, IT strategy committee and IT investment committee. Representatives from both the business and IT should lead to a common understanding of company goals and objectives. Intuitively you would expect that the CIO of a company is the focal point of IT governance. However the scope and the importance of IT governance are so immense that it needs the involvement of the Board. As the CIO is not automatically a member of the company board, it is essential that a member of the Boards mentioned above has a solid understanding of technology.

⁵ [DeHaes04], page 6

⁶ [TNCC05], page 6

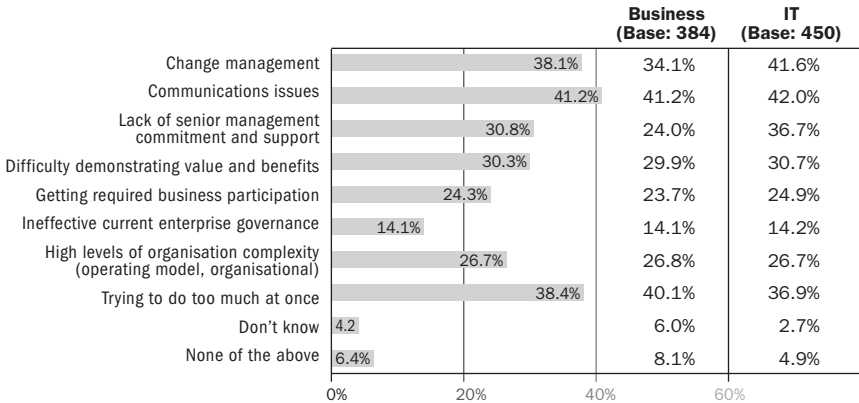
However the main players are not limited to the areas of business and IT.

Current key challenges

A survey conducted by ISACA in 2010 within 834 business and IT executives resulted in the following overview (*Figure 1*) of current challenges in implementing governance mechanisms.

Figure 1:

CHALLENGES IN IMPLEMENTING GOVERNANCE MECHANISMS



The bars within *Figure 1* show the average percentage of agreement to the presented challenges from business and IT (indicated on the *right side* of *Figure 1*).

The top 3 challenges ('change management', 'communication issues' and 'trying to do too much at once') according to this survey are all related to project/program management. If the timeline is unrealistic or resources are not in place as needed for the progress of the project/program, too many uncoordinated tasks/projects are going on in parallel. If the governance program is not treated as a companywide change program, the necessary change management will face major resistance to change. And communication issues are also common symptoms for incomplete or incorrect project/program setup or mistakes in the project/program delivery.

Compared to the before mentioned key challenges, 'Difficulty demonstrating value and benefits' in the survey from *Figure 1* goes in the same direction as 'Inability to measure governance capabilities in an objective manner'. These challenges come back to the questions: How does a company measure value and performance? What indicators will be

measured? How can IT performance indicators be mapped back to business performance indicators? How can non-monetary values of measuring be transformed to monetary values?

It is interesting to note that the business side and the IT side of respondents do not differ significantly in their answers. The biggest discrepancies can be found at 'Change management' and 'Lack of senior management commitment'. It seems understandable that business respondents rather answer that the commitment of senior management is sufficient and change management is working properly. The reason behind this may be that these areas are likely to be within their responsibility and they do not want to appear in a bad light. The concurrence for the rest of the answers lead to the assumption that both sides have the same issues and a common approach to minimize the related challenges would benefit both.

Why IT Governance?

Why has IT governance gained more attention over the last few years? One clear reason is the more prominent role that IT plays in various companies. This in part is related to the fact that more intangible assets make companies valuable. "An ever larger percentage of the market value of enterprises has transitioned from the tangible (inventory, facilities, etc.) to the intangible (information, knowledge, expertise, reputation, trust, patents, etc.) [...] While IT is fundamental to sustain what may be unglamorous and taken-for-granted business operations, it is equally essential to grow and innovate the business."⁷ Especially industries with a high degree of intangible assets need to concentrate on making those assets measurable. IT governance can help.

The business side increases expectations on IT departments and they need to respond to it; amongst others these expectations are related to achieve economies of scale for products and services.

⁸The main question is what happens if companies do not apply IT governance? Will it have a significant business impact and support business strategy? How can the relationship between IT governance and the business impact be made transparent?

In order to increase company value and to minimize risks, company performance needs to be measured and benchmarked. The General Accounting Office correctly stated that "in an effective performance management approach, measures are not used for assigning blame or to

⁷ [ITGove03], page 13

⁸ [GAO98], page 4f.

unknowingly comply with reporting requirements. Quite simply, they are used to create and facilitate action to improve performance. Measures and performance information must link to strategic management processes. [It should provide] an early warning indicator of problems, [...] input to resource allocation and planning [...] and] periodic feedback to employees, customers, stakeholders, and the general public about the quality, quantity, cost, and timeliness of products and services.”

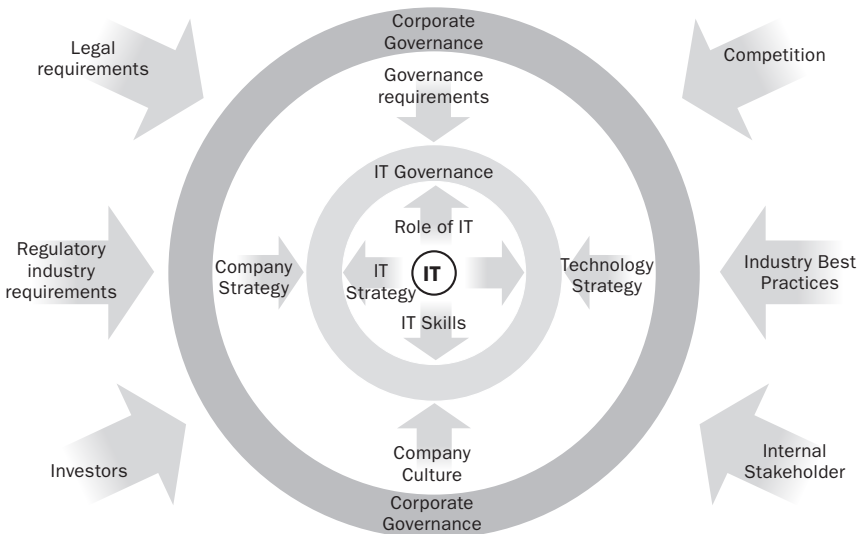
The performance results should be the basis for any decision making process and the fundament for periodic business/IT alignment. Optimized alignment can “assist a firm in three ways: by maximising return on IT investment, by helping to achieve competitive advantage through IS [Information Systems], and by providing direction and flexibility to react to new opportunities.”⁹

Influencing factors for governance

Figure 2 gives a graphical overview of influencing factors to corporate and IT governance.

Figure 2: **INFLUENCING FACTORS TO CORPORATE GOVERNANCE**

[own graphics on the basis of A. Rüter et al. ¹⁰]



⁹ [Avison04], p.225

¹⁰ [Rüter06], page 11

Legal and industry regulations generally dominate corporate governance. Shareholders are willing to pay a premium for well governed companies, while stakeholders have increasing levels of influence. Last but not least, well governed companies that market their efforts in corporate governance in the right way will likely get a competitive advantage over companies that are not that advanced.

Influences on IT governance can be categorized into those that result out of corporate governance activities and those out of the IT. Company strategy and derived technology strategy as well as general governance requirements should have an impact on IT governance. Company culture also plays an influencing role because the changes imposed by IT governance should be accepted by employees and the whole organization as they are part of implementing the governance structure. IT itself also effects IT governance. The role (supporter vs. enabler) and maturity (including relevant IT skills) of an IT organization are important attributes to consider. In addition, the IT strategy if derived from the business strategy has a stronger influence.

Not adequately reflected in *Figure 2* is the influence of the customers and the market itself in which the company operates. Ultimately, it is they and their trust in the company that make a business profitable and successful or not.

To what extent these factors force corporations to apply governance structures for IT depends on its features and requirements. Those can be categorized as by B.Cumps et al. in descriptive variables such as country, industry, company size, turnover, company culture, level of customer intimacy, ICT Strategy (conservative, essential, innovative), Business Strategy (Operational Excellence, Product Leadership, Customer Intimacy).

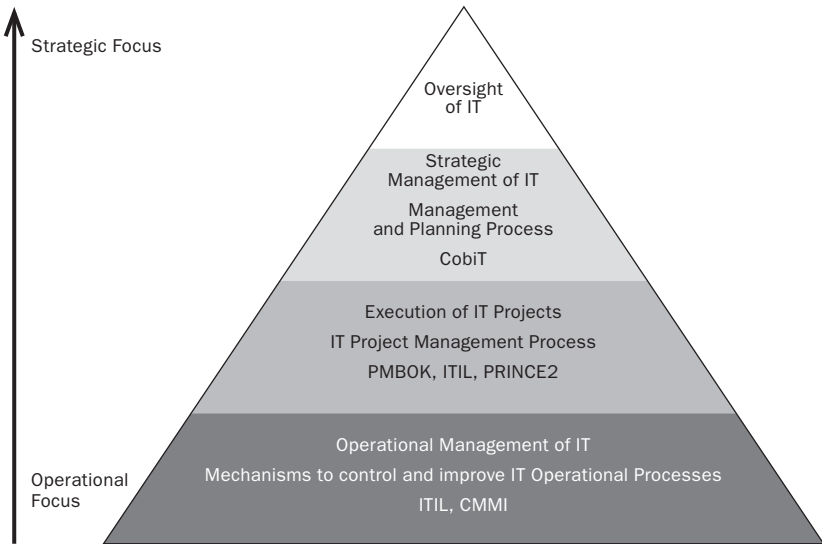
Relevant Structures and Frameworks for Corporate and IT Governance

A variety of frameworks is available both for corporate and IT governance. COSO Internal Control-Integrated Framework and Enterprise Risk Management-Integrated Framework (<http://www.coso.org/>), OECD Governance Principles (<http://www.oecd.org/daf/ca/corporategovernanceprinciples/corporategovernanceandthefinancialcrisis.htm>) and King Code III (<http://african.ipapercms.dk/IOD/KINGIII/kingiiicode/>) just to mention a few.

For IT Governance the following *Figure 3* shows where specific IT frameworks can be used and in relation to what focus.

Figure 3: **FRAMING OF IT GOVERNANCE**

[own graphics on the basis of CIO Executive Board ¹¹]



Strategic and operational foci for IT can be identified. On the top level the oversight of IT is done in-house. Information regarding performance of key indicators of IT is consolidated at that level. On the next level (strategic management) an umbrella framework such as CobiT can be used to manage and plan relevant processes. The next level involves the execution of projects/programs influenced by the strategic management of IT. Established project/program management frameworks such as PMBOK and PRINCE2 should be used for that. The basis and foundation for the pyramid and IT in general is the operational management of IT – mechanisms and controls to keep the IT operational and to support/enable the business goals. A widely spread framework for this layer is ITIL. The maturity of the processes used in that layer can be measured through CMMI. Some of the mentioned frameworks offer the possibility to map those to the corporate governance or internal control frameworks, which obviously would create benefits through a consistent approach. We will concentrate in the good practice section on those.

¹¹ [CIOEXE08], page 3

Good Practices for (IT) Governance

What are good practices for governance and how can those be achieved? Good practices refer to generally accepted and proven approaches for different activities.

The focus of the following sections will be on good practices within corporate and IT governance via a mixture of frameworks. Two main approaches will be taken:

- 1) Good Practices by putting together a **holistic framework mapping corporate governance frameworks with IT governance frameworks** downwards to the operational level. In other words a combination and mapping of separate frameworks from the business/internal control and IT (operations) side.
- 2) Good Practices for the **subdomains of IT governance** – Strategic Alignment, Value Delivery, Risk Management, Resource Management, Performance Management – emphasizing the implications on the strategic side.

To what extent the good practices within the frameworks/models can be applied depends on the features and requirements of the company.

Good practices: From COSO to CobiT to ITIL

The positioning/mapping of three frameworks in close alignment will be demonstrated by using the COSO, CobiT and ITIL v3 framework.

The goals and objectives as well as supporting frameworks of corporate and IT governance are similar, however, expressed in different terms and vocabulary. Translation/alignment work has to be done in order to get a common understanding.

The following best practice exercise will use a combination of business and IT related governance frameworks. This approach guarantees that a maximum of information gets mapped through the combining frameworks and avoids misunderstandings between the different involved parties.

One-to-one mapping between the frameworks and best practice structures is not possible. Each framework has a different target audience; hence the framework fulfills different roles for them. While COSO is primarily focusing on fiduciary processes, CobiT focusing on information to control IT, ITIL is looking for a vendor-independent approach for service management. However all of those frameworks are looking for control of environments. If a mapping between those is used, an end-to-end (from business to IT service management) relationship is created and implications and importance of certain areas are getting more transparent. Control is an essential part of a corporate's strategy implementation and (re)alignment.

Let us start the mapping from the business side. **COSO** published the ‘Internal Control – Integrated Framework’ in 1992. The processes between the five internal components - control environment, risk assessment, control activities, information and communication, monitoring - of COSO should enable an organization to achieve an organization’s mission, strategies and related business objectives (see also¹²). Business goals and derived business processes should be incorporated into the internal control system and should provide amongst others a basis for setting up the control environment. IT is one of the control environments that need to be considered.

The **CobiT** framework (see also¹³) fulfills the COSO requirements for the IT control environment and for that reason is a natural extension of the COSO framework towards IT. CobiT aligns business with IT goals, and breaks those down into processes, activities inclusive accountability and responsibility. It also offers the possibility to measure performance and maturity of IT processes. Ultimately CobiT framework’s goal is to support business goals and objectives. In order to do this these goals will be broken down into IT goals. These IT goals will be achieved by one or more of the 34 IT processes within the CobiT framework, each one associated with specific process goals.

In publications, e.g. from IT Audit¹⁴ a high-level mapping of COSO’s five internal components to CobiT’s 34 control objectives is suggested.

ITIL with its perspective on the life cycle of services of an IT organization and all supporting components needed to deliver services to the customer (see also¹⁵) minimized the risk of “inefficient services provided to users and customers, dissatisfaction of users and customers with services provided and misalignment of IT services and business requirements”¹⁶.

Ultimately ITIL support the implementation and control of a company’s strategy by delivering high-quality IT services.

The CobiT framework also offers a mapping from its IT processes to ITIL v3 core topic and key areas¹⁷.

With this mapping approach from COSO to CobiT and from CobiT to ITIL v3 a bridge is established from an internal control system that supports business objectives and focuses on the IT control environment in our case to an IT Service Management good practice publication. ITIL v3 provides

12 [Rüter06], page 121

13 [ITGove07]

14 [TioIA04]

15 [itSMF07]

16 [Isaca11], page 23

17 [ITGove08], page 23ff

a complete perspective on the life cycle of services of an IT organization and all supporting components needed to deliver services to the customer. With this approach a bridge gets established from business processes and objectives to operational focused elements that are also associated with the business process objectives.

Good practices within IT Governance Focus Areas

Here we take a closer look at the subdomains of IT governance and connecting those to an overall IT governance process flow supporting corporate strategy.

According to the IT governance Institute, five subdomains need to be considered within IT governance. The five subdomains are interconnected and cannot be viewed isolated. “[It] is important to note that GEIT [Governance of Enterprise IT] objectives, regardless of their priority at a particular time, are related (e.g., an emphasis on value delivery will impact resource management). Therefore, GEIT initiatives must take a balanced and holistic view of the five GEIT focus areas (strategic alignment, risk management, value delivery, resource management, performance measurement). [As an example] during an economic crisis, when there is a strong focus on managing cost, effective GEIT can ensure that this focus is balanced with a view on investments that can generate cost savings and are ultimately self-funding.”¹⁸

Strategic IT Alignment

The starting point of implementing IT governance is the strategic IT alignment, the alignment of business and IT objectives. Business objectives are influenced by stakeholders and should first be analyzed and drive the following process within the other subdomains.

IT/Business Alignment is one, and probably the most important one, out of five subsets of IT governance according to the IT Governance Institute. This alignment “represent[s] the process and goal of achieving competitive advantage through developing and sustaining a symbiotic relationship between IT and Business.”¹⁹

To achieve the alignment the business goals should be mapped and translated into the company’s IT goals. Usually, the business goals are rather generic and use a different terminology as the IT goals. For the mapping of goals the following guidelines should be adhered to:

¹⁸ [ITGove11], page 7f.

¹⁹ [Duffy02], page 4

- **The goals should be realistic and achievable:**

Although these characteristics are evident there is still the chance that for political reasons or, due to hidden agendas, the goals set will not be achievable. This should be avoided.

- **The goals should be measurable and indicators for success should be set:**

Without the possibility to measure the baseline state and future state, the goals cannot be met. Also variables should be known that lead to a certain goal to success or failure. By adjusting these variables the goal can be fine-tuned.

- **The reverse mapping of the IT goals to business goals should be possible:**

If the IT goals get mapped back to the business goal, the reverse mapping leads to the same result as the original mapping.

- **The achievement of the goal should be mostly in control of the IT:**

Goals that can only be achieved if other corporate departments lead certain activities, but do not get rewarded for it directly; these goals are likely to be missed. IT goals should be set in a way that the IT department has maximum control over the achievement.

- **Develop goals from a given baseline state:**

Having a baseline set of variables that influence the achievement of the goal before setting the goal makes it easier to set realistic and understandable goals.

- **For the agreed timeline for the goal consider resources and budget needs:**

If a lot of resources such as people, infrastructure, hardware, software are needed. If budget or availability is not confirmed, the timeline may not be met. Another point to be considered is the availability of third parties if needed.

Value Delivery

The next subdomain that will be focused on is – value delivery. What is IT value, how can it be defined? Let us ask the question that is usually associated with value: “Are we getting the benefits? Answering this question requires asking:

- Do we have a clear and shared understanding of what constitutes value for our enterprise?
- Do we have a clear and shared understanding of the expected benefits from new investments, and resulting IT services, assets, and other resources?

- Do we have clear and accepted accountability and relevant metrics for realising the benefits?
- Do we have an effective benefits realisation process over the full economic life cycle of our investments to ensure that we are getting optimal business value?”²⁰

Various views of IT value exist. “Different levels of management and users perceive the value of IT differently. [...] To be successful, enterprises need to be aware that different strategic contexts require different indicators of value. This means that it is important to establish the value measures in concert between the business and IT.”²¹ If in the first step the language between business and IT get aligned, it will be feasible to find common indicators of value. Examples for these indicators are:

- Business growth: Examples of variables for measuring the growth of businesses are turnover, market share profit, staff numbers
- Productivity: To measure productivity the ratio of output from a (production) process to the input per measured element has to be considered
- Innovation: An example for value of innovation is to gain a competitive advantage and attract new customers. To achieve this value strategic investments have to be executed which will not immediately result in new revenue streams. Therefore, strategic goals like ‘enhance time to market for innovative products’ have to be validated carefully before implementing.
- Customer satisfaction: Happy, satisfied customers are extremely valuable. High customer satisfaction will lead with high probability to continuation of current contracts and expanding the scope of projects with those customers.
- Delivery of projects within time, budget, quality: There are several reasons why successful project delivery is of value. First, it creates usually satisfied customers (see above). Second, the timely delivery of projects preserves resources and hence decreases costs. And third, it saves the company from contractual penalties, hence, prevents threats to profit margin.
- Fully integrated services: A single consolidated approach across internal and external services reduces bureaucracy and provides control over efficient and effective service delivery. This will decrease (process) costs and likely increases revenue.

²⁰ [ITGov08b], page 16f.

²¹ [ITGove03], page 25f.

Independent of the indicators used, it is essential to focus on the creation and conservation of value. An increase in value will help a company to grow.

Risk Management

Risk is a relative value and the management of risk depends on the company's attitude towards risk. It is essential for companies to be able to forecast implications of risk exposure. What happens if problems occur, e.g. main supporting IT services or functions within the company are offline for a longer time? What does it cost to preserve the value? What is the damage in terms of financial loss, reputation etc.? Also an important question is who is ultimately responsible?

The Institute of Risk Management (UK) recommends in its risk management standard the following responsibilities for boards:

“The Board has responsibility for determining the strategic direction of the organization and for creating the environment and the structures for risk management to operate effectively. This may be through an executive group, a non-executive committee, an audit committee or such other function that suits the organization's way of operating and is capable of acting as a ‘sponsor’ for risk management. The Board should, as a minimum, consider, in evaluating its system of internal control:

- The nature and extent of downside risks acceptable for the company to bear within its particular business
- The likelihood of such risks becoming a reality
- How unacceptable risks should be managed
- The company's ability to minimise the probability and impact on the business
- The costs and benefits of the risk and control activity undertaken
- The effectiveness of the risk management process
- The risk implications of board decisions”²²

“Effective risk management begins with a clear understanding of the enterprise's appetite for risk and a brainstorming session on the high-level risk exposures of the enterprise.”²³

Depending on the answer of above questions, ways of dealing with the risk can be discussed and decided upon. In general there are three ways of dealing with risk: Mitigate, transfer, and accept. Although accepting risks seems counter intuitive initially, it could be a viable option if the implications are analyzed and the decision was made that the company

²² [Instit02], page 14

²³ [ITGove03], page 27

can live with the combination of risk implication and risk probability. No option for a company is to ignore risk.

What does risk management mean and imply if IT gets involved? “IT risk is the business risk associated with the use, ownership, operation, involvement, influence and adoption of IT within an enterprise. IT risk consists of IT-related events that could potentially impact the business.”²⁴

IT risk and business risk cannot be separated. Even if IT or IT services are not a product for the company, but rather an enabling mechanism, IT is still vital for the vast majority of companies and leaving IT out of risk evaluations would be damaging.

The link to the strategic planning (business side) to avoid isolating IT risk management activities has to be considered.

Resource Management

Resource management is about “ensuring that the right capabilities are in place to execute the strategic plan and sufficient, appropriate and effective resources are provided. Resource management ensures that an integrated, economical IT infrastructure is provided, new technology is introduced as required by the business, and obsolete systems are updated or replaced.”²⁵ It is recommended to widen the scope of resource management to also include assets as defined in ITILv3 such as knowledge, information, infrastructure, applications etc. This guarantees that not only the HR related resources or IT assets are considered, but also other assets that need to be contemplated to deliver end-to-end services or products.

Performance Measurement

The last and essential element is the measurement of performance within IT governance. This element closes the feedback control system and enables continuous improvements.

Performance measurement is “tracking the achievement of the objectives of the enterprise’s IT-related services and solutions and compliance with specific external requirements. Without establishing and monitoring performance measures, it is unlikely that the previous focus areas will achieve their desired outcomes. It provides a link back to the other focus areas by monitoring that the required direction is being followed and creates the opportunity to take timely corrective measures, if needed.”²⁶

As the monitored parameters are IT related, they must be translated back into business terms to show their impact on reaching business

24 [ITGove11], page 48

25 [ITGove11], page 48

26 [ITGove11], page 48

objectives. Ultimately, the measurement of performance indicators is vital to get transparency on costs and risks and how to minimize them. A clear focus on costs has to be established and the performance indicator's metrics should be able to get translated into monetary values. As a result "it is likely that there will be opportunities to make financial savings as a consequence of implementing improved IT governance. These will help to gain support for improvement initiatives."²⁷

Connecting the dots of good practices within IT governance subdomains

According to the IT Governance Institute "successfully implementing GEIT depends on several factors: change management, communication, proper scoping and identification of achievable objectives. [...] The outcomes of a successful implementation are worth it, producing both shorter-term, tangible benefits such as reduced cost and longer-term benefits such as enhanced management of IT-related risk, improved relationships between business and IT, and increased business competitiveness."²⁸

The IT governance process²⁹ connects all mentioned subdomains. It is driven from stakeholder values into a continuous improvement cycle.

The stakeholders (internal and external) dictate the business strategy. The strategy is usually captured in the business goals. The business strategy needs to be mapped to the IT strategy, which again gets implemented in IT processes and underlying activities. These processes utilize IT resources. The utilization level of these resources should be constantly measured and compared to an agreed baseline. Once the process is implemented the results of it will include outcome of the process, the performance of the process and risks associated with the process. The results of the process are measured and fed back to improve the process efficiency and effectiveness. Thus, the process confirms or changes the strategy that was initially set. The IT governance process is a self-correcting/improving process. The reported results will be fed back into the business strategy so that improvements/changes can be initiated.

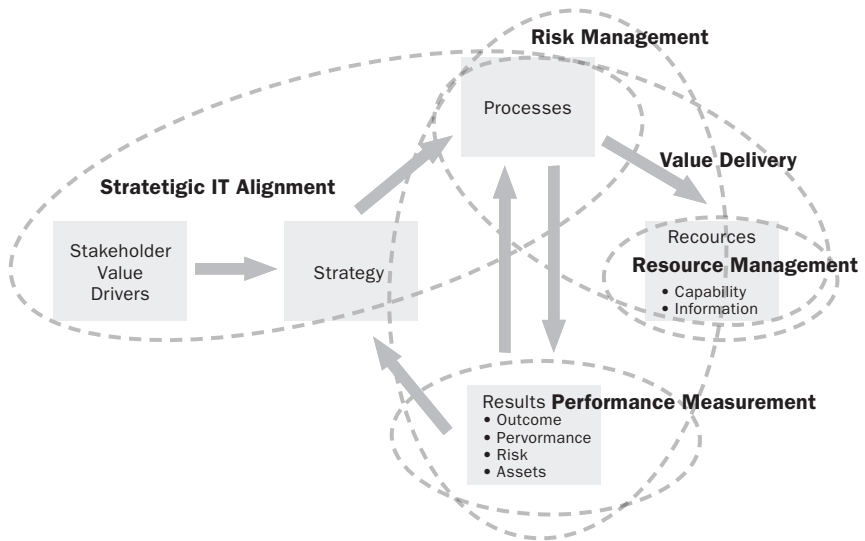
If we map the IT governance subdomains into that process flow, it can be seen in *Figure 5* that they cannot be strictly separated but rather give input or output to other subdomains.

²⁷ [TNCC05], page 8

²⁸ [ITGove11], page 8

²⁹ [ITGove03], page 21

Figure 5: **IT GOVERNANCE PROCESS**³⁰
WITH IT GOVERNANCE SUBDOMAINS [own graphics]



Strategic IT alignment involves *stakeholder value drivers*, *strategy* and *processes* from Figure 5. All of those processes are needed to establish an alignment between business and IT goals. Stakeholders give the initial input, which gets captured in the business and IT strategy. This strategy needs to be implemented using defined processes.

The **value delivery** subdomain predominantly needs the input from the defined *processes* and resources that are used to create value within these processes. Beforehand an agreement of value has to be found between business and IT and the value concept formulated using key performance indicators and a baseline to start from.

Resource management needs resource and capability information on the *resource* process (see Figure 5). An inventory of resources or assets as well as a utilization level of those are important input factors for resource management.

The **risk management** subdomain utilizes predominantly the *processes* and the *results*. The reason for that is that only from the processes, which impose or which relate to risks and from the associated results adequate risk management can be derived. Marginally, some elements of strategy and resources influence the management of risks, too.

30 [ITGove03], page 21

The last subdomain performance management utilizes the results gathered. Based on the initially defined values and key performance indicators, the performance level of governance can be measured and reported.

Only the complete implementation of all IT governance subdomains offers the chance to approach IT governance in a holistic way and supports corporate's strategy meeting stakeholder values.

Corporate governance and IT governance are integrated in this approach to a successful unit. Business strategy is the input for the process development and the implementation of those within IT. This is the basis for the alignment.

Concluding Remarks and Outlook

IT governance is needed as an integral part of corporate governance. Both governance approaches have the goals to increase the company's value and decrease the risk involved in the daily business and strategy implementation of the company.

Currently, IT is in most cases still the execution arm for corporate wide strategy where IT systems and IT infrastructure are required; however IT governance should have a much more prominent role. The stakeholders of corporate governance need the stakeholders of IT governance and vice versa. Implementing company strategy without IT components is not possible in most cases. On the other hand, stakeholders of IT governance need IT budgets approved by corporate governance stakeholders. This dependency on both sides can be optimized by integrative structures.

IT governance supports corporate strategic goals through the alignment of business related and IT goals. Only through that alignment it is guaranteed that priorities and objectives are synchronized and are approached jointly.

A "collaborative relationship [between business and IT stakeholder] demands that both business and IT managers take responsibility for business operations and IT innovation, which is achievable only when stakeholder constituencies share their unique expertise and competencies. This emerging paradigm for IT governance is based on a 'philosophy' of collaboration where the need for distinct competencies is recognized and developed, and shared adaptively across functional, organizational, cultural and geographic boundaries." ³¹ In the future the importance of IT governance in general will increase. Companies will be getting under pressure from their stakeholders to transparently

31 [Peters04] page 73

publish benchmark data outside of the mandatory published company information. A holistic approach towards governance from corporate and IT is needed to achieve this.

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2

Chapter 9
INTRODUCTION**Overview of Boards and Governance***Philippa Wells & Jens Mueller*

The purpose of this chapter is to provide rationale, background and context for the chapters that discuss the Board of Directors and its composition. By way of introduction to this section it is worth referring to the OECD (2004) where it states that ‘The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board’s accountability to the company and the shareholders’ (OECD, 2004, p.24). Clearly, its three main roles are to determine strategy, monitor management and to account to shareholders for the use of company assets and resources (Carver and Oliver, 2002). In achieving those roles, the Board is responsible for ensuring legal requirements are met (including those specifying the form of financial and other reporting to shareholders and, if listed, the requirements of the particular exchange or other body involved in determining rules).

It is unarguable then that an effective Board of Directors (or its equivalent) is pivotal for good corporate governance and performance of companies and other organizations (Bainbridge, 2008; Bale and Dale, 1998; Borokhovich, Parrino and Trapani, 1996; Coles and Hesterley, 2000; Hazeldine and Quiggan, 2005; Petrovic, 2008), with the board having leadership, monitoring and accountability functions. Fundamental to the question of whether and when a board is effective is motivation: the reasons why individuals join and participate in boards, and criteria: why particular individuals are deemed desirable potential directors. As a preliminary point, it is often assumed that optimum characteristics and mix of members on the Board of Directors and optimum incentives that will attract that optimum mix are universally or at least generally applicable. However, directors of the small to medium size company may have very different objectives, priorities, characteristics and focus to the large corporate (Bennett and Robson, 2004; Mueller, Dana, McDonald

and Maier, 2006) as might those responsible for governance of different types of organizations and in different socio-cultural contexts.

Therefore, it is very possible that a one-size fits all approach is unsuitable in determining why Directors join boards and therefore the incentives that will attract them, maximise their effectiveness and encourage them to stay. It is also very possible that some directors may be motivated to serve not because of personal advantage but because they wish to provide some support and add value to the firm and its members.

There are further aspects of expectations of the board that are highly relevant to the question of effectiveness. First there is the matter of its responsibilities, for what and (particularly in the world of theories such as stakeholder and stewardship that shift attention from shareholder value as THE focus for governance to the whole gamut of interest groups and constituents) to whom. With the “triple bottom line” reporting standard and “balanced score card” review process, the societal pressure is on companies to report not only on financial results but also on their social responsibility and environmental sustainability (Epstein and Roy, 2005). Also, it is generally agreed is that any board should protect the interests of owners and investors (van den Heuvel, van Gils and Voordeckers, 2006), evaluating and controlling management performance, providing access to extra resources, determining the manager’s responsibility, maximising the shareholder value and determining the salary/compensation of management.

In addition, it seems obvious that boards should be both effective and efficient, a “fact” that raises questions over the workload and related costs and commitments associated with board meetings (such as with the Directors in the case of ASIC v Healey and Ors [2011] FCA 717 (the Centro case)).³² In this instance, Directors were expected to read and absorb copious pages of board memos and agenda documents – a task they argued was impossible. However, these need not be enormous. The Wal-Mart Board, for one of the largest companies in the world, meets in person only four times a year (Lockhart, 2007).

Vafeas (1999) actually concludes that firm performance suffered from too frequent board meetings.

³² The Directors of the Centro Group were found in breach of the Corporations Act 2001, ss 180(1) (statutory duty of care) and 344 (statutory duty to ensure compliance with financial reporting duties). Justice Middleton rejected the argument made by the Directors that they were entitled to rely on advice given by the auditors (PriceWaterhouseCoopers) and the CFO as to the effect of a new accounting standard, and stated firmly that they were required to form their own opinion as to the compliance of the accounts (in this case A\$2 billion was wrongly categorised as non-current liabilities).

Also of direct relevance are the motivations that drive managers as it is these that determine how this officer can be “encouraged” to put the company first. As pointed out earlier, the general assumption that emerges from the body of governance literature is that the board must control and supervise management to ensure it acts to benefit the owners of the firm (the shareholders). Underlying this assumption is the premise that if appropriate mechanisms are not in place, the manager will act in his or her own self-interest (Milgrom and Roberts, 1992). This assumption ignores the influence of such factors such as friendship, cooperation, familial ties and interpersonal or person-firm loyalty that might affect the manager/director/owner relationships.

All the above raises the question of what a board and its membership should look like. The traditional view is of a group of individuals (middle-aged white men) with significant experience in the market within which that company operates and with significant experience of the workings of that company. The membership of such boards was also traditionally and overwhelmingly constituted by company insiders, including family members (if a family company) friends, professional advisors (lawyers or accountants) or substantial shareholders or their nominees (Gordon 2007). However, in more recent years this “norm” has been increasingly brought into question, most particularly, although not only, via a push to have the board populated by other than insiders.

The presence of “outsider”, “non-executive” and ‘independent’ directors (who may share common characteristics but are not necessarily the same) was resisted in jurisdictions dominated by the Anglo-American model of a unitary board (having the roles of both supervision and management). Some objections to the idea of independent directors are listed by Zandstra (2007), albeit recently, but likely to be very similar to those voiced 20 years ago. Inter alia, those include the fact that for many such directors their interests are artificial (lacking strong links between the company’s wellbeing and their own) a characteristic that reduces their motivation to maximise performance; they may lack experience and understanding of the business environment; they may well have a seat on a range of boards, reducing loyalty and adversely affecting their focus on the company and its wellbeing. In addition, and depending on the individual, they may perceive the position of director as a chance to strengthen or maintain social or business networks, affecting the degree to which they are truly independent (Zandstra, 2007, p.3). Despite such objections, however, the independent director is increasingly mandated or encouraged by legal and

quasi-legal rules applying in a wide range of jurisdictions including the UK, countries in Europe (Germany, France and others) the US, Australia and New Zealand.

However, this also raises interesting issues for motivation. Arguably, inside directors would assume positions on the Board because it is part of their role in the company (such as that of the Chief Financial Officer) or because they hold equity in the company either through purchase or, more likely in the case of a senior executive, as part of their compensation package. Outside or independent directors might join for a variety of good reasons. Cortese and Bowrey (2008); McCabe and Nowak (2008); Pass (2004); Peterson and Philpott (2007); and Spencer Stuart (2009) all report that a large proportion of independent appointees come from business backgrounds, including serving or ex CEOs/Directors of other companies. In addition, the Higgs Report (Higgs, 2003) and McCabe and Nowak (2008) warn of a tendency for existing board members to approve the candidature of those most like them. Such directors might join as a result of their business, social or other links with existing members of the board (Nwabueze and Mileski, 2008) and as a means of increasing their business power or influence (Borokhovich, Parrino and Trapani, 1996). Other factors include maintenance of founder-family control or influence over a listed company (Demott, 2008), a wish to inculcate particular ethics or values into corporate decisions or strategy (Kemp, 2006), contribute to a drive to bring a sense of social responsibility or broader cultural expertise to the Board (Agrawal and Knoeber, 2001; Cunningham, 2010) or as part of a move to introduce ethnic or other diversity (Women on Boards, 2006; Spencer Stuart, 2009). Such directors are not necessarily driven by money (He, Wright, Evans and Rowe, 2009) but more from a desire to “do good” (whatever that means).

Other concerns revolve around performance of members of the board. Le Blanc and Gillies’ (2005) uncovered a significant problem with disfunctionality. Inter alia, respondents considered that the board, particularly the independent members, was seen as a low-value impediment to the CEO’s performance rather than as a valuable aspect of management and strategy, and even more worrying, cited the lack of trust between the Board and management, lack of commitment on the part of their fellow directors, strong personality conflicts and problems with the way Board made decisions.

Again, the variability of expectations and demands placed upon directors or their equivalent is going to be important in determining how performance

is to be assessed and the evaluation of that performance. Boards of large for-profit and non-profit firms might be formal in their operations and take care to accord with statutory or regulated procedures (McNamara, 2010). They often have small executive committees and possibly many members, some of whom are highly visible in society (McNamara, 2010).

By way of contrast, boards of small non-profit or for-profit firms might be informal, with informal operating methods. McNamara writes that there are many similarities between non-profit boards and for-profit boards. Both types of board have similar fiduciary responsibilities among members. In addition, both have to conform to operating rules and regulations set by the state and by the firm itself. For-profit board members usually are paid and tend to deal closely with decisions the firm's financial operations with a view to maximising the firm's profits. However, board members on non-profit boards are volunteers. They are not paid, except for expenses and do not seek to maximise profits but instead are often involved with fundraising (McNamara, 2010).

Such variability can affect board attributes and, ultimately, its contribution to organization performance. As some indication, Norburn (1986) reported how certain variables in industry settings, growth, turbulence, and decline, helped to shape directors' characteristics, abilities, beliefs and skills. He found that directors in growth industries demonstrated certain characteristics, including wide exposure to other cultures, and an inclination to use participative decision styles. In turbulent industries, directors valued career mobility, had little international exposure, and were people-oriented in their managerial styles. In declining industries, directors were motivated by monetary rewards, had little international exposure and were older than directors in other industries.

As a starting point, a board is a complex organization that must rely on the collective strength provided by its members. Individual directors must accept a common responsibility to form an effective working group (Demb and Neubauer, 1992). Although certain individuals and groups are clearly more influential than others, board members usually see their boards as homogenous groups of colleagues who have similar socio-economic backgrounds, and who work together on a consensual basis (Hill, 1995; Westphal and Milton, 2000). Historically and persistently, board members are usually men, often with extensive experience in top management positions, with similar interests, and similar social and professional networks. Although some appointments from a pool of candidates may be controversial, board members are traditionally selected from those

already in the professional networks of the CEO and the other board members, and new members' qualifications may not be scrutinized (Huse, 2007). Independent, or outside directors, are recruited primarily because of their expertise and reputation. Arguably, this communality has many advantages, such as common knowledge of the informal rules of the game, and a rapid grasp of issues to be discussed and decided (Huse, 2007).

Accordingly, current board recruitment practices appear to be more closely aligned to the needs and demands of key internal actors who are generally considered to be the top management team (Huse, 2005). Having the same business background, non-executive directors usually subscribe to the same dominant business ideology as the executives. This means that they may intervene reactively rather than proactively in executive decisions and therefore be less effective as a check on management hegemony, although they still serve to constrain managerial opportunism (Hill, 1995; Huse, 2005).

Given the above, Hill's (1995) study of boards as social organizations in major British companies is interesting because respondents (both executive and non-executive directors) identified certain personal attributes of non-executive directors ('breadth of vision', 'a broader perspective', 'a global view of the company and environment') that seemed more desirable than was expertise in a particular area. What was needed were suitable people (Ruigrok, Peck, Tacheva, Greve and Hu, 2006), who could not only work with the existing members but also provide vital support for the firm in a changing environment (Ruigrok, et. al, 2006). Carefully identified and recruited members of a diverse group might offer the best chance of this, given their quite different experiences, and thus different attitudes on issues or problems. Such diversity can be seen as a means of conduit for representation of a range of interests held by a range of stakeholders and promoting those interests to the board through the medium of on-going relationships. Hence there has been an increasing emphasis in many jurisdictions – but with variable results and with both support and resistance– on increasing levels of diversity (gender, race , age and background) on boards.

Conclusion to this Section

A board is a group of people, selected for their expertise, who work together to add value to the organization they lead. Although diversity in boards of directors far from being a requirement per se, it is crucial in the service role, but not in the strategic role. There is much more to

board composition than director selection and achieving the right skill mix, important as these elements are in assembling balanced boards. Boards need to be aware of the potential to add value through the pool of board capital contributed collectively by their directors as a strategic resource for their organization. This board capital is a measure of the value added by the board in its governance. Researchers have linked board capital directly to the provision of resources and firm performance, according to resource dependence theory.

Thus boards may need to focus first on merit criteria for director selection, seeking qualified individuals and reflecting in the mix, gender and a range of expertise, experience and personal attributes. Shareholders may be unmoved by the gender debate, for example, and prefer to hire exclusively for performance.

Despite independent directors being identified as the crux of good corporate governance and despite moves in a range of small and large, developed and developing countries to make them a requirement or at least a very strong recommendation for public companies, the empirical evidence of their effectiveness achieving their touted purposes – of increasing shareholder value and monitoring the executive of the company – is by no means clear. Numerous studies show positive, negative and no effect on corporate governance practices or policy of their membership on the Board while others utilise a range of data sets to map the characteristics and nature of independent directors. Also some recent empirical studies seem to indicate a deep malaise on some Boards, which, if carried through to governance practices and decisions suggest that the presence of independent directors is just not achieving good outcomes.

A common message that seems to come out of the literature is that independent directors per se are only one aspect of corporate governance and, as such, cannot be considered the one shot panacea to corporate ills. It is necessary to go further and both look at how they fit into the raft of policies and practices adopted by the company and at the qualities they bring. Although in this regard there is a distinct preference for those with business experience (preferably in the same area of business if not in the company itself) there is also some sentiment favouring those with a wider world view, sentiment consistent with the social support for the display of social and other responsibility by the company. This then begs the question: what characteristics should new or potential directors have?

The issue of recruiting new board members has been explored in the context of both for-profit boards and non-profit boards (Brown, 2007).

In 2007, he examined whether using recommended recruitment, board member orientation and evaluation practices resulted in more competent board members and if the presence of these board members led to higher board performance. His results supported the hypothesis that using board development practices did lead to more capable board members and the presence of these board members led to stronger board performance. Ansari (2010) recommends recruiting board members who have a variety of backgrounds to enable them to engage with a diverse range of stakeholders.

To provide guidance into how a wish list of such potential directors should be compiled, McNamara (2010a) developed a director recruitment grid (see appendix). This grid provides structure for research into an individual's suitability for a position on the board. McNamara (2010a) further suggests that the most important consideration when recruiting new board members is the range of skills needed at the time. He also recommends that board development committees maintain an up to date list of potential board members which identifies the skills that individual could contribute.

Finally, McNamara (2010) recommends that the board chair and CEO meet potential board members in order to impart gain a clear understanding of the firm and to receive a board member job description. Any potential conflicts of interest with the candidate must be identified. The prospective board member should be invited along to a board meeting and introduced at the beginning. Shortly after the meeting, the prospective board member should be contacted and asked whether they would like to join.

Insofar as process of recruitment is concerned, often a new board member will be recruited by word of mouth, which raises the question of how objective the search might be. Current board members may recommend an individual or an open position may be made known by word of mouth (Ansari, 2010), supporting the concerns that director appointments are decided by insiders, and possibly not based on criteria that would ever allow outsiders to be considered. Zablacki (2007) also confirms the above suggestion. Good networking facilitates recruiting new board members and most often a prospective board member will be someone a current board member already knows (Zablacki, 2007).

However there are executive search consulting companies that specialise in 'board services'. Spencer Stuart is a multinational executive search consultancy firm that offers a firm access to a database containing information on potential independent directors for a company. Spencer Stuart claims that there is a greater need for independent directors in

particular given recent changes to corporate legislation and governance codes (Spencer Stuart, 2013a). It offers to assist firms in finding and researching potential directors (including independent) and conducts more than 400 searches for directors every year for companies around the world.

In addition, some board members are recruited through the use of public advertisements. Den Hartog, Caley and Dewe (2007) examined the use of advertisements for this purpose. They compared all job advertisements that appeared in a prominent public domain (The Times Newspaper, UK) and found that out of the total number of advertisements (4217) that appeared over the course of 15 months, 1390 were for leadership positions such as chairperson, CEO or director. Hartog et al.'s analysis highlighted the terminology of the adverts most successful in attracting ideal candidates for leadership roles. They found that the terminology such as 'people oriented' and 'transformational' were used far more than terms describing traits such as 'task oriented' or 'transactional'.

In the instance of non-profit organizations, boards are generally composed of founders and substantial donors who serve as volunteers. Hence their willingness to maintain their personal donations of wealth or time and, presumably, some ideological affinity to the purposes of the organization, is commonly an implicit condition for membership (De Andres-Alonso, Azofa-Palenzuela and Romero-Merino, 2009). Recruitment of board members in non-profit organizations can therefore be self-perpetuating.

Traditionally, companies seek board members by having someone suggest a prospect, which they then pursue (Gottlieb, 2005). Most board will recruit new members by having existing board members put forward names. The nominee will generally fill out an application form and attend a meeting or two, after which they may be asked to join the board (Gottlieb, 2005).

It is advisable to put in place a process for recruiting board members, writes Gottlieb (2005), whether it is to replace existing board members or to begin an organized programme to recruit new members with skills complimenting those currently represented around the board table. Particular attention should be paid to ensuring diversity on the board although Zablocki (2007) claims that recruiting for diversity is hard. Often the perfect candidates are identified, researched and approached, but the answer from these paragons is often no.

Standard advice is for the board to develop a wish list of potential candidates whose backgrounds and circumstances are then checked for details such as wealth, giving capacity, giving history, volunteer

involvement, educational background and business relationships. It is also important that the right person in the organization be identified to approach recruits. The final list should then be reviewed by the board development committee to ensure that the right potential recruits will be approached. It is further suggested that the full board should agree before this is done. Finally, should the recruitment be successful, the new board member ought to be encouraged to immediately get involved in meetings and events.

An important preliminary step in determining how to recruit qualified board members with such a commitment is understanding the motivations of board members in non-profit organizations. Cleave and Inglis (2006) suggest that future research with a focus on individuals serving as board members will help determine and understand the necessary human resource strategies needed to increase the skills and effectiveness of board members. This affects the recruitment and retention of board members by allowing organizations to better understand what they are looking for in a candidate and allowing a candidate to assess if they are able and willing to fill that position. By understanding key motivations of potential board members, organizations and their nominating committees will be able to strategize effectively on their specific recruitment strategies (Ansari, 2010).

In small family businesses, boards of directors tend to be recruited 'in house'. The results of a pilot survey conducted by Johannisson and Huse (2000) suggest that entrepreneurial firms avoid recruiting outside directors. Contrastingly, managerial firms actively welcome outside directors. Family-run businesses were ambivalent on the issue.

Chapters in this Part

The chapters that follow offer insights into how these various theoretical insights, academic debates and reported concerns have influenced and shaped boards of directors (or the equivalent) and their operation/effectiveness.

In **chapter 10**, Ladegård, Hansen and Buehrmann report on comparative research into how director candidates are identified and appointed. The study offers some valuable and thought-provoking insights into how a person may be seen as addressing the needs of any particular company in terms of human capital and also the ways in which the concrete expertise/characteristics required by the company also have symbolic meaning.

Erakovic and McMorland refer to a rich data set of New Zealand non-profit organizations in their exploration (in **chapter 11**) of governance

challenges such organizations face in transitioning from voluntary associations to formally structured agencies. They argue that developing the governance capacity and collective capability, built on adoption of best practices, diversity of ideas and experience, sound protocols and systems, and strong relationships amongst board members, between a board and the CEO, and amongst the board and the organization's stakeholders, is of key importance for an agency in order to position itself within the sector. They conclude that a well-designed board is crucial in achieving this outcome.

The balance of this part is made up of specific discussions around how a board, as a pivotal aspect of governance, can and should function so as to maximize its effectiveness and how the understanding of foci and direction of governance might vary as amongst those affected. In **chapter 12** Berrone and Garcia-Piriz report on such variance from their research that explored the link and relationship between boards and institutional shareholders, reporting that institutional investors tend to be concerned about directors independency, professionalizing board member status or protecting minor shareholders. On the other hand, board chairmen were more concerned with fair and equal treatment of shareholders, strengthening the position of the firm within the market, increasing gender diversity in the board and strengthening its strategic vision as the main challenges ahead. In short, institutional investors tend to favor corporate governance issues and aspects that secure short-term profitability while boards tend to favor long-term and strategic elements.

In **chapter 13**, Lockhart examines the role of the company board in the strategy setting process, and its importance in maximizing the performance of the company. He argues that if boards are to be responsible for an organization's performance, and held responsible by various third parties, then that outcome should reflect their contribution - or lack thereof - to corporate strategy.

Finally in this part, Chowdhury and Sheppard (**chapter 14**) offer a salutary tale about what can go wrong where a board fails to react swiftly and correctly to issues around a company's reputation. They describe how Toyota's poor corporate governance - especially of its board contributed to its fall from the No. 1 spot in car manufacturing. and report that it took Toyota CEOs and its entire insider-dominated board more than 10 years to acknowledge the existence of safety problems plaguing its cars, let alone initiate any corrective measures, a failure that affected its international reputation for reliability, customer care and safety.

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Chapter 10

Exploring Director Recruitment: What Characteristics Constitute an Appointable Candidate?

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Abstract

We investigate how professional recruiters perceive and assess potential board director candidates. Based on a human capital perspective, individual characteristics will represent certain human capital resources, perceived as more or less useful for the firm. We focus on what characteristics are critical for a candidate to be perceived as appointable to a board. We are particularly interested in the role visible vs. more hidden aspects of human capital in these assessments. The aim of the study is to uncover central actors' ideas and assumptions of what constitutes the ideal board director. This will add knowledge as to how board compositions are created and changed.

We conducted eight semi-structured, in-depth interviews with professional recruiters in Germany and Norway. The results show that formal competence is partly downplayed as selection criteria for board positions, while experience has a central role. Further, our results show that experiences have both a concrete and a symbolic side, where certain individual characteristics appear to represent an image of a successful director of a board. Further, our data show that symbolic capital, labelled “habitus”, is a crucial prerequisite for an individual to be appraised as an ideal candidate. The results indicate preferences for stability and predictability in recruitment processes, which may contribute to explain the persistently low proportion of women on corporate boards.

Introduction

Corporate governance “codes of conduct” have become a widespread tool for improving governance, and the recent financial crisis in many countries has prompted codes that are increasingly comprehensive and detailed. Following this trend, several countries have added an additional

corporate governance principle, gender diversity on boards of directors.³³ However, despite increasing normative pressure to appoint more women directors, the proportion of women on corporate boards throughout the world has been increasing extremely slowly. This indicates that, when companies replace departing directors on their boards, they tend to select new directors of the same gender as those who have left (Farrell & Hersch, 2005). This raises the broader issue of recruitment practices to corporate boards, and warrants a closer look at the individual human capital determinants of director selection. Despite a substantial body of research on director recruitment (for a review of this literature, see Withers, Hillman, & Cannella, 2012), few studies have investigated potential director candidates and the characteristics of those who are selected for board positions compared with those not selected. Some studies have addressed specific characteristics that may enhance individual chances of receiving a board appointment (e.g., Westphal & Stern, 2006, 2007; Zajac & Westphal, 1996). However, we know little of the composition of characteristics that constitutes an ideal director candidate.

This study addresses this question by investigating how professional recruiters perceive and assess potential board director candidates. Withers et al. (2012) categorize the director selection literature from two perspectives. From the rational economic perspective, directors are appointed based on their ability to provide resources to the firm, or to carry out specific board functions, whereas the social embeddedness perspective addresses the social processes driving the selection of candidates. We focus on which characteristics are perceived as critical for a candidate to be assessed as appointable to a board director position across disciplinary perspectives. The aim of the study is to uncover central actors' ideas and assumptions of what constitutes the ideal board director, and why. Based on their review of the director selection literature, Withers et al. (2012) concluded that the processes through which directors are selected are rarely discussed in the literature. This paper addresses this gap by identifying how central actors – professional recruiters – make their judgments and decisions on which candidates to include as potential directors, before the final appointment decisions are made by their client firms.

A couple of preliminary points should be made. First, it should be recognized that recruitment processes may vary substantially between firms, and we have chosen to focus on the commonalities of human capital

33 For example, Australia adopted this principle in 2012, the UK in 2011, and Germany in 2010 (<http://www.ecgi.org>).

requirements for director appointments across firms and industries. Thus, comparisons between types of firms or industries are beyond the scope of this paper. Secondly, we believe that professional recruiters with long experience are valuable sources of knowledge on the process of director candidate selection, across firms and industries, and, thus, interviews with these individuals fit our purpose. In focusing on the views and perspectives of recruiters, our aim is not to obtain an objective picture of the actual selection criteria after-the-fact; rather, we seek to understand both the explicit and the underlying assumptions guiding the appraisal of potential director candidates, as well as the meaning ascribed to different human capital characteristics relevant to board positions.

As mentioned above, Western countries are experiencing rapid changes in how corporate governance codes are formed, but there are substantial differences between countries. We have chosen to focus on Norway and Germany in our study, as these two countries have quite different corporate governance guidelines, which may reflect different cultures on gender equality and women in management. In Norway, a quota rule regarding female directors has been in effect for four years,³⁴ and experiences of recruitment of women are beginning to surface in the discourse on this topic. As more women are recruited to large companies as a consequence of the changes to legal requirements, this may affect recruiters' perceptions of women as potential corporate directors. The German Corporate Governance Codex includes a principle of gender diversity; however, it is a "comply or explain" principle, as there are no sanctions tied to nonconformance to the Code. Further, Germany and Norway differ on several cultural and social characteristics, such as educational levels, participation in the labor market, and gender equality (Hausmann, Tyson, & Zahidi, 2012; OECD, 2012; Zahidi & Ibarra, 2010). The specifics of some of these differences and how they relate to director recruitment will be discussed further throughout the paper.

Germany has a dual board structure, with both a supervisory board and an executive board, whereas Norway has a single-tier structure, with only a supervisory board. The purpose of a dual board structure is to ensure that the supervisory board is acting independently of the executive management of the firm, as one of its roles is to monitor the management of the firm. However, as Norwegian law prohibits the CEO being a board member and strongly advises firms to have independent

34 The quote rule requires publicly traded companies to have at least 40% of each gender on their boards.

directors on their boards, we believe that the supervisory boards in the two countries are quite similar with regard to their roles toward the firm. Thus, we decided to limit our study to focusing on recruitment to supervisory boards only, as we consider these boards to be comparable between the two countries.

A Human Capital Framework

Our aim in this exploratory study is to detect the broadest possible set of relevant criteria underlying recruiters' assessments of potential candidates. Therefore, we selected a comprehensive human capital theory framework for this purpose, as suggested by Ployhart and Moliterno (2011). The individual-level components of human capital resources are labeled knowledge, skills, abilities, and other characteristics (KSAOs). The general properties of the knowledge, skills, and abilities (KSA) components are well defined in earlier research, and the "Os" (other characteristics) provide us with the freedom to include other characteristics that may be considered by the focal actors as relevant, as well as our interpretations of the meanings attached to those criteria. The individual-level KSAOs are further categorized along two dimensions: cognitive characteristics, the so-called "can do's" (such as knowledge of a specific industry), and noncognitive characteristics, the so-called "will do's" (such as values that may guide a person's choices). This distinction is particularly relevant for our study, as the perceptions and assessments made by our respondents include both appraisals of the contents of a person's human capital, as such, as well as anticipation of how some of the characteristics will determine this person's behaviour and choices in the future, i.e., as a director on a board. Thus, our questions as to why specific criteria are judged to be important for board positions will assist us in investigating how these characteristics can be used as clues to the future performance of a potential director. The individual human capital categories in our framework, together with examples of each category, are shown in *Table 1*.

Table 1. CATEGORIES OF HUMAN AND SOCIAL CAPITAL

(adapted from Ployhart and Moliterno, 2011)

	Category	Examples
Cognitive characteristics ("can do")	Knowledge	Knowledge of accounting or law
	Skills	Analytical skills Strategic skills
	Experience	Business experience Industry experience
	General cognitive ability	Intelligence
Noncognitive characteristics ("will do")	Personality	Agreeableness
	Interests and values	Ethical values Preferences for tasks

However, the categorization in *Table 1* is not comprehensive in the sense that all individual characteristics that may be relevant for a board position are included in the table. Rather, we apply it as a starting point for our empirical exploration. Taking full advantage of the "Os" in KSAOs, we decided to discover anything our respondents may consider relevant in their assessment procedures.

Ployhart and Moliterno's framework includes two other dimensions of human capital that are relevant for our purposes. First, they argue that unit-level human capital (in this paper, board-level human capital) is not merely an aggregate of individual knowledge, skills, and experience; rather, it is emerging as a board-level resource as members interact over time. This implies that board-level KSAOs are flexible and can be changed, both through turnover and recruitment, as well as through emergence-enabling processes on the board over time. Further, the individual sets will vary depending on the fit between members at the board level. From this viewpoint, board-level human capital is labeled human capital compilation rather than the commonly used composition. Compilation of a unit is based on the heterogeneity of lower-level phenomena that develops over time, whereas composition is an assembly of homogeneous parts (Ployhart & Moliterno, 2011). We interpret a compilation modus of board recruitment as a process whereby optimization of the board-level human capital is underlying the search for relevant candidates, contrary to the search for a candidate with a profile similar to the one to be replaced.

Compilation as the basis for recruitment requires diligent analysis of the human capital on the board to rearrange the set of KSAOs available on the board and to build a diverse profile of the whole board, including the incoming director. Lynall, Golden, and Hillman (2003) proposed that, over a firm's life cycle, changes in board composition become increasingly unlikely because departing directors are replaced with candidates with similar characteristics. They labeled this tendency "path dependency". Thus, although we believe that board-level human capital is the ultimate goal in any board formation procedure, the board-level human capital is not a preexisting, empirically detectable variable in our study. Rather, we use our interviews to investigate to what degree board-level human capital is included in the recruiters' assessments of potential candidates.

The second dimension included in human capital theory is the nature of the different human capital characteristics as being context specific or context generic. Some of the KSAOs are likely to be relevant and required across boards and industries, whereas others will be specifically related to the firm in question. We are particularly interested in the relative importance attached to human capital resources related to the client firm in comparison to generic human capital characteristics.

Design and Method

Sample selection

For our sample, we undertook a purposive selection (Silverman, 2005) of eight respondents from recruitment and selection consultants and other consulting actors in Norway and Germany. Our selection was based on the following considerations. First, we were interested in experienced actors who could refer back to many cases of recruitment to corporate boards, including recruitment of women directors, when formulating their responses to our questions. In Norway, we selected four of the most well-known recruitment companies and asked for an interview with one of the senior partners (respondents N1–N4). In Germany, we selected two of the leading executive search companies specializing in the recruitment of leading personnel, among those members of supervisory boards (respondents G1–G2). Additionally, we selected one representative of a company that specialized in the assessment of management personnel, and the CEO of a nonprofit organization that provides a database on qualified women candidates for boards (respondent G3–G4). All organizations have histories going back more than 50 years. All of our interview partners in both countries are senior partners/members of the executive board of

their organizations and have been personally involved for many years in recruitment for top management positions as well as for boards.

Interviews

We considered that the best method for our explorative approach to recruitment practices was to interview key informants, as interviews make it possible to gather rich information and have open-ended questions that allow for reflections by the interviewee, and for simultaneous reflections by the researchers on the information given during the interviews (Silverman, 2005). Further, the interviewees reported on the practices of their companies in the search and selection processes as well as their own perceptions, opinions, and emotions on these topics. However, we believe that the recruitment process cannot be made fully transparent through empirical research because it has different meanings for the people involved, and, further, it is a process that is socially constructed during our research (Alvesson, Hardy, & Harley, 2008). Taking these issues into account, we found that a “cultural script” approach to the interviews was most appropriate. In describing interviews as cultural script applications, Alvesson noted, “the interviewee must rely on established cultural resources for describing issues at hand. This means that available vocabularies, metaphors, genres, and conventions for talking about issues – cultural scripts – are used” (Alvesson, 2003: 20). In short, we are interested in the “sayable”, but we also looked out for the “unsayable” throughout the interviews.

As our data collection relied on retrospective recall of recruitment experiences, we aimed to reduce the bias of memory to a minimum by being as specific as possible in our questions. Thus, we first asked each respondent to keep in mind the latest recruitment assignment they had accomplished and we commenced the interview with specific questions regarding the human capital considerations of that specific assignment. We then probed for answers using follow-up questions and broadened the questions to encompass generalizations, beyond the specifics of the case in focus. Thus, we aimed to capture as detailed measures of the human capital characteristics as possible, and, at the same time, to elicit the meanings and values connected to those characteristics. Further, we asked our respondents how they perceived the human capital attributes to be related to the future performance of a board director. By doing this, we obtained a picture of why certain characteristics were more valuable than others because they were used as clues to anticipate the underlying attributes of an individual, or as predictions of future behaviour.

The interviews were conducted in the native language of the respondents (German and Norwegian). The interview guide was first developed in English and then translated into German and Norwegian. Full transcriptions of each interview were undertaken, and we translated the main parts of the transcripts into English using skilled translators. The researchers from each country then read the transcripts from the other country, and discussed them to ensure that interpretations were similar across settings.

Data analysis: Coding procedures

The analyses followed the procedures described as “grounded theory” techniques (Corbin & Strauss, 2008). First, we conducted processes of open coding separately in Norway and Germany, in the respective native language. The concepts gained from this coding process were translated into English. We summarized the concepts, properties, and dimensions in a shared excel file. The concepts were all interpretations of the meaning found by the researchers in the text (Corbin & Strauss, 2008: 160). The second step was the axial coding process, during which we structured the codes defined in the open coding and concentrated them to gain a consistent level of abstraction. We aimed to stay as close as possible to the original wording of the interviewees. As the end result, we received a set of categories to be used to understand the characteristics of an ideal director candidate as perceived by our respondents. We connected these categories to the categories in *Table 1*, discussed above. The coded categories are shown in *Table 2*.

Table 2. **OVERVIEW OF RESULTS: INDIVIDUAL CHARACTERISTICS**

	Individual Level	Categories
Cognitive characteristics ("can do")	Knowledge	Formal competence Specific expertise
	Skills	Soft skills Skills on strategizing
	Experience	Business experience Industry experience Board experience Leadership, media experience
	General cognitive ability	Intelligence
Noncognitive characteristics ("will do")	Personality	Type of person Agreeableness Integrity and authenticity
	Interests and values	Openness and trust
Symbolic cues		Reputation, social status Social–personal cultural style Being decent, having manners Being "one of us" Social power

Results

Knowledge and experience.

Both formal knowledge and different forms of experience were considered to be basic requirements that all candidates should possess. An interesting aspect was how the recruiters discussed the relationship between these two variables. Specifically, the importance of experience was underlined. There appeared to be a difference between the Norwegian and the German respondents, as the following comments indicate:

They should all have a theoretical platform. This should be at a high level, preferably an MBA in addition to more specific knowledge, such as laws or finance (N3).

I think, for board members, their experience is important. Formal qualifications – if they are bankers, accountants or if they are university professors – that all depends on the position on the board that you want to assign (G2).

It appeared that formal qualifications were generally required in Norway, but were not required to the same degree in Germany, where context-specific business experience was considered crucial. This may

relate to the fact that higher education is far more common in Norway than in Germany. According to OECD, in Norway, 41% of 25–34-year-olds have a tertiary education (i.e., university or college level), whereas the proportion in Germany is 26% (the OECD average is 38%) (OECD, 2012). Further, more women than men in that age category have tertiary education in Norway. However, in all interviews, experience was declared to be the most fundamental requirement, and the Norwegian respondents emphasized that experience should complement formal education. Often, context-specific experiences connected to the strategic issues of the firm were referred to:

The formal education is the platform, and on top of this you need work experience, either from relevant markets or internationally, and you should have worked with similar issues as the focal company is facing. We are quite specific on these experiences (N3). And of course the subject's international experience ... The companies try to get access to international networks by recruiting members of supervisory boards with international experience (G4).

Further, leadership experience was considered a prerequisite for candidates to be appointable:

First and foremost, I think board members should have operational leader experience. In my eyes, they also need to function as a good leader team for the management, because that is what they do. And the larger and more complex the business, the more important leadership experience is. So being on the Telenor board or Orkla board without having operative leadership experience can quickly lead the board to being overridden by the management (N1).

And understanding – being able to translate a strategy into tactics and action, and understanding that you can give better advice to the management if you have previously been in the shoes of a leader, and you know where the shoe pinches. And then you won't be fooled by the "that's impossible", because you have been there yourself and you know that it's possible (N1).

The latter two quotes indicate that experience is an asset vis-à-vis the management in a company, implying that earlier experience from top management will enable a director to take a stronger role in monitoring the management team of the focal firm. The top management team is powerful, and for the board to be able to fulfill its monitoring and advisory role, the directors need to take a leadership role toward the management

team. Consequently, experience may give them the “weight” they need. Experience is apparently the one resource that contributes strongly to the power position of a director, and power is considered to be important. However, experience not only functions as a resource in itself, but is also used as a symbol of a person’s social status, and an indicator of underlying characteristics. Experience as a signal for reputation and intelligence enhances the trust bestowed on experienced candidates:

It is about reputation and intelligence... If you look at people who have been exposed to public pressure, how they have handled it, whether they did a good job, you can assume that it will work. Or having worked in an environment with strong labor unions [...] if you have worked in ARCUS, which has Norway’s strongest labor union, you understand this (N1).

Experience was described both as generic and as context specific. One of the generic aspects of experience was related to present or past board appointments. As a response to a direct question, all the Norwegian interviewees asserted that they had never recruited a board member who had no previous experience as a director. Generic business experience was also defined as important in Germany. Lack of experience was identified as one of the reasons for the small numbers of women on German boards:

That is a very important point. So, by experience I mean, where, in which “world” he has been. Has he been a director of bakery chain A, or the director of B elevators. B elevators has a transaction volume of four or five billion whereas bakery chain A has a substantially lower turnover. So, that has to fit. And that’s an important point why there are so few women. Because so few women have reached that management level. And that is the main problem for the assignment of women to board positions, as we look for directors with senior management experience (G2).

The perceived lack of women with experience as a CEO or director is supported by statistics on women in management from the two countries. Germany has a substantially lower proportion of women in top positions than Norway. In 2010 in Germany, 6% of CEOs were women, whereas in Norway, 12% were women. Further, 81% of all German firms had no women on their boards, whereas in Norway, only 16% of the companies had all-male boards (Zahidi & Ibarra, 2010).

Regarding the type of experience that was reported, context-specific experience, such as industry experience, was considered an important

resource for performance of the strategic role of the board, while generic experience was considered to be important for the relationship toward the top management team:

We recently carried out a board recruitment where we actually first helped hire a new CEO, and we hired someone who was competent and powerful enough that the chairman said that we needed more expertise in the board – in order to match the new CEO and give him the challenges he needed from the board to be a good leader (N1).

It appears that the more experience a person has, the more attractive he or she is as a candidate. Our impression was that this often led to older candidates being selected, sometimes candidates beyond the official retirement age. Taking a rational economic perspective would suggest that the value of length of experience was limited, but this did not appear to be the case from our interviews. We believe that this indicates the symbolic aspect of experience, where age and length of experience function as a symbol for status and social power. For example, there was no mention of any boards wanting younger, technologically skilled or innovative directors on their boards. This does not mean that such candidates are not relevant in some circumstances, but rather, that they do not readily fit with the stereotypical image of an ideal director candidate. This is partly in accordance with earlier findings. For example, Pass (2004) found that the average age of non-executive directors in their sample of large UK boards was 59 years. The largest group of companies had an age average of 60-64 years among non-executive directors, while none had an age average below 50. Only two had an age average of 65+.

Finally, we interpret the symbolic value of experience as a means to reduce risk – directors with long business experience proving that positive results were considered as low-risk appointments. Thus, stability and predictability appeared to be more valued than specific competences related to the firm's strategy.

Skills.

Some personal skills were considered to be basic competences that, along with formal education, every candidate should possess, rather than being a discriminating criterion:

Well, and the other things are taken for granted: that they are able to communicate and to resolve a conflict etc... and that they are in some degree sovereign. This actually is standard (G1).

For a supervisory board member, soft skills are more important than hard skills (G2).

Well, first of all it is certainly everything that deals with strategic skills. People who are able to formulate a vision, derive strategies, anticipate social development, observe the market and – depending on the branch of industry – who can anticipate developments of the market, too. That is the whole strategic area (G1).

However, the importance of soft skills over formal qualifications, emphasized by the German respondents, was not fully shared by the Norwegian respondents. The Norwegian respondents stressed specific experience, considering it to be an indication of skills. The question is, how do recruiters observe and assess skills? Skills were quite directly tied to perceptions of a candidate's ability to carry out board tasks and to the social processes required on a board, such as teamwork and decision making.

When discussing experience, the gender issue was brought up several times. The discussions revealed that most of our respondents felt that recruiting women was more difficult, because there are fewer women who have the experience needed:

Women candidates are harder to find, it has always been like that, qualified women are not out there in the same numbers as the men (N2).

We also interview female executive board members and female supervisory board members. And those that I have experienced, they are extremely tough. And, that's clear, there aren't a lot of them (G2).

There was a unanimous perception that qualified women candidates were harder to find than men. Considering the small... proportion of women in top management positions in both countries, this is no surprise.

Summing up the above human capital categories, it appears that some knowledge and skills are basic requirements for being seen as a potential director candidate, while experience – both generic and context-specific experience – is the discriminating characteristic between potential candidates and ideal candidates from the recruiters' point of view. Further, we found that the amount of experience possessed seems to be the determining criterion. This criterion is clearly contributing to less recruitment of women.

Other characteristics: Personality, interests, values.

These characteristics are of particular interest in our study for several reasons. First, they were mentioned far more times during our interviews than were the knowledge, skills, and experience characteristics. Further, they are more difficult to assess and measure during a recruitment process. As they are “will-do’s”, they are more indirectly tied to board performance, and prediction of future behaviour of candidates based on these characteristics is more difficult. We found that personality and values were most often related to social processes in the boardroom by the recruiters:

The higher the position, the more important role personality plays. That’s old wisdom (G2).

The contribution of a director is based on openness and trust; you need the soft values, to be able to listen and to have engagement for the company (N2).

Consequently, it is not only a question of skills, but also about attitudes. And it is particularly about aspects which are concerned with personal integrity, loyalty, etc. – leadership ethics (G1).

... that you have to be decent, that you have manners. This is what I mean by ethical competence, leadership ethics, integrity, loyalty – these terms. And by now this is explicitly formulated as job requirements (G1).

We are looking for someone who asserts himself or herself, who goes into conflicts, who is good in communication, who is good in presentation, who is rather confident and who has a specific empathic style – so that he or she is able to understand what his or her team needs. This could be defined by default; however, it differs among companies (G4).

During the discussion of personality and value characteristics, women were not explicitly mentioned by our respondents. Some of these characteristics, such as soft skills and empathy, are traditionally associated with female values, and are probably not harder to find among women than among men. The value of these attributes was particularly tied to ability to work in a group, cooperate, and fit in with the present board:

We do also ask about this – what type of person can you work with, what is the culture in the organization like (N1).

Large organizations with a matrix structure are team-oriented, and you have to make sure there is interplay and cooperation

between the actors. You need humble people (N3) but you need to be able to assert yourself too (see G4).

A large part of these attributes relates to being accepted by the present board. The recruiters reported that they usually select three candidates to be presented to the group responsible for appointments to the clients' boards. During the discussion of these characteristics in our interviews, most of the respondents focused on how these attributes were assessed. The ability to cooperate and contribute to teamwork was directly related to how they would "fit in" with the existing board. The respondents specifically mentioned this as an issue when the candidates are presented to the chairman and other board members, before the final selection. To a large extent, "fitting in" was based on symbolic cues. Because personality and value attributes are not readily detectable from previous experiences, they are based on a few meetings, some interviews, and assessments based on visible or expressed clues:

The moment of truth is when people meet each other. We could do this very comprehensively, but if you, so to speak, "cut the crap", you get into what makes people react negatively to a person in a boardroom. Some people you don't like working with (N4).

He came in ... and he had this cloth tucked in here. And this stuck out and he smelled unbelievably of perfume, some men's perfume. Incredible. We did have a perfect talk. It was ... everything fitted. In the end, the client told me: "Did you see that? And how he smelled? I don't want him!" Yes, these things also play a role. And it means nothing else than that I somehow match my peer group (G2).

We had a candidate who really was fantastic as an entrepreneur, I thought. But a couple of the technology guys thought he was too much of a salesman type of person (N4).

The quotes above indicate that different cues are used to assess whether a candidate fits in with the existing board. It was during the discussion of fitting in that gender was most often mentioned by the respondents. In relation to the KSAs, the low number of women was explained by the fact that there are fewer women with the long experience and reputation in comparison to men. Regarding the "Os", however, the "fit problem" was stressed, especially in Germany:

By the way, the attitudes of the women who are supposed to be in these positions also have to be similar. They have to share

the values and so on and be on eye level and so on. That's clear. Man or woman, native or foreigner, that doesn't matter. However, women and foreigners bring in different aspects also value-wise. A lot of times they have different values (G2).

One can add another aspect to that: my observation of women in the top league today is that they often imitate the men. And they believe that, if they act the same, it's going to work out with each other. That's correct. Because the ones that try it differently, will be out again. OK, I think Mrs. A of company B, she tried a different style. I don't know many details about this case, but I can imagine that that wasn't well received. However, I see that as an issue in transition. I think that will change, but these women are exotic today though (G2).

Some Norwegian respondents refused to view gender as an issue:

Diversity is no longer a trend. The gender dimension is virtually non-existent, it's nothing new. But I think ethnicity is becoming increasingly important, as well as international expertise (N1).

I have never, and I mean never, experienced gender as an issue, except from when it was about discrimination (N4).

This last comment indicates that although gender is not explicitly on the preference list when recruiting directors, the respondent had experienced discrimination issues. Moreover, despite these comments, it became obvious that gender remains an issue in Norway in general:

To improve the gender balance, you often appoint one of the "golden skirts", and you pick well-known names from the media.

These are few, and often have a large number of board positions, and do not have the time and engagement that is required (N3).

Professional recruiters have large social networks that are used as bases for selection of potential director candidates. Women do appear to be included, although to a lesser degree, in those networks, so media is used as a source and signal of reputation. Few people are well-known through media, and women may be more reluctant to expose themselves to public scrutiny, further decreasing the probability of "being found". The result in Norway is that there are a few women who have quite a large number of board appointments. Thus, gender remains an issue in Norway, as in Germany, but it may be that the quota rule has made it less politically correct to see this as a problem.

It was quite clear that the German respondents had a stronger perception of women as "different", meaning not fitting the stereotypical image of a

director. It appeared that women in Germany, to a larger degree than in Norway, remain associated with the traditional social roles of housewife, mother, or spouse. This is supported by statistics. In 2009, the labor force participation rate for women in Germany was 53.1% (66.8% for men), whereas it was 63% in Norway (71% for men) (Hausmann et al., 2012). In the Global Gender Gap Survey conducted by the World Economic Forum in 2012, Germany was ranked number 31 (out of 135 countries) on “economic participation and opportunity” for women, whereas Norway was ranked number 4. Further, the gender gap in earnings is large and increasing in Germany, whereas it is decreasing in most other OECD countries (OECD, 2012). On average, across all OECD countries, a women with higher education can expect to earn 33% less than a man with the same level of education, whereas in Germany, she can expect to earn 44% less than a man (up from 39% in 2000 – the gap has actually increased). Thus, the traditional “male breadwinner family” model appears to remain strong in Germany. We believe that a part of these gender differences is due to women working shorter hours and having part-time jobs.

The notion of fitting in is also related to whether the present board accepts the candidate, which appears to largely be based on personal liking:

Well, if you are in a hurry for a good leader, and have a project that must start immediately, I think it is very easy to say about a candidate that “nah, he’s not quite there, but there’s probably potential...”. I think this happens often, and especially if they have a personality that appeals to the person on the other side. It tends to be “this was a likable person - someone who’s a real charmer” (N1).

The importance of the personality and value characteristics of a candidate – the “Os” in our KSAO framework – was related to the potential director fitting in and being liked, more than to the quality of the characteristics per se. This was different from how experience and formal education were assessed. Further, the notion of fitting in was associated with the relationship between the individual versus the board-level human capital. Our respondents wanted to base the selection of candidates on a compilation view of board-level capital, i.e., to address the board, and its changing needs, as a whole. However, while the recruiters wanted their clients to rethink the composition and the whole board, most often their clients wanted simply to replace the departing board member:

I think there is just no rule for finding a member with a certain profile because this is the way it goes: if X leaves the board,

having created a distinctive profile, a person is required to fit into this profile because the board just does not change, it just replaces. If an attorney leaves, another attorney simply takes over his position. That is the favored option (G2).

We go in and “put our finger into the eye” of the client and say, “have you really thought about this, are you replacing someone who left the board? Why?” and we have a lot of questions we ask and get a discussion (N3).

The change versus replacement issue was an area where the recruiters felt they could contribute to creating a better board, but the standard procedure for board appointments appears to be an individual being replaced with a similar candidate.

Discussion

Our results show that there exists a set of human capital characteristics that are regarded as assessment criteria for being appointable to a board, and that these criteria are guiding recruitment and selection processes. Thus, in line with previous findings, we conclude that no single characteristic is sufficient to discriminate among potential candidates, and an integration of theoretical perspectives in research on director selection is warranted (Withers et al., 2012). However, our study reveals that some characteristics scarcely addressed in earlier research appear to be important for candidate selection. We specifically want to address two issues here. The first is that several of the human capital characteristics assessed by recruiters have both a concrete and a symbolic aspect. For example, experience is not only valuable because of the skills and knowledge it generates, but it also functions as a signal of other, underlying characteristics. For example, long business experience may be perceived as signaling stability and predictability, and will thereby place a person on top of an informal power hierarchy in the business community. Further, the tendency to select women who are well-known in the media indicates that media exposure symbolizes similar qualities. The “fit” question was also based on symbolic clues that were loosely related to competence as a board member, such as appearance and attitudes. Thus, our results indicate that several symbolic aspects of human capital characteristics that were not included in our initial theoretical framework may be important determinants of which potential candidates are selected and which are not. The symbolic aspects may contribute to explaining the consistent lack of recruitment of women to board positions. The socioeconomic and cultural differences between

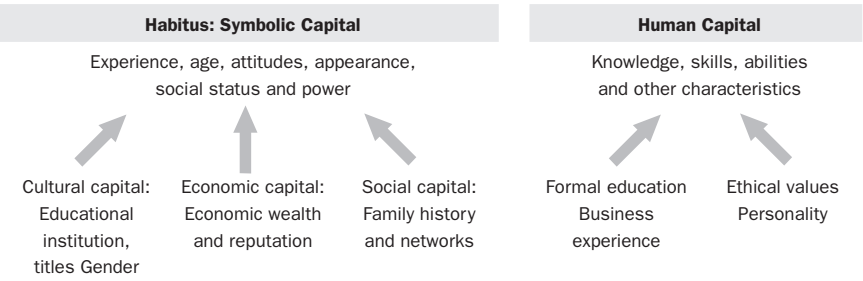
Germany and Norway also appear to manifest themselves in symbolic ways, as the view of women as “different” was stronger among the German than the Norwegian respondents. We suggest that these symbolic aspects should be labeled symbolic capital, and added to the theoretical framework presented earlier.

Bourdieu (1986) discusses the concept “habitus”, which is related to symbolic capital. A person’s habitus is created through different other types of capital: economic capital, cultural capital, and social capital. These types of capital are converted – as “external wealth” – into an integral part of the person and are not recognized as capital at the individual level, but rather as “legitimate competence” (Bourdieu, 1986: 49). Thus, the habitus is different from human capital in the sense that it has a symbolic value, although it is developed from the three forms of capital. Bourdieu explains habitus as “systems of durable, transposable dispositions that function as structuring structures, that is, as principles which generate and organize practices and representations that can be objectively adapted to their outcomes without presupposing a conscious aiming at ends or an express mastery of the operations necessary in order to attain them” (Bourdieu, 1990: 53). Thus, an individual’s habitus can be interpreted as a generative structure providing and reinforcing specific dispositions to act (Vaara & Fay, 2011). As the habitus represents predispositions to act in practice, we could expect that a certain habitus may be perceived as appropriate for board candidates because a person with a proper habitus will be expected also to behave properly, according to general as well as specific norms, in business and on a board. Thus, the habitus provides the recruitment agent with a set of clues about possible future practices of the candidate.

Maclea, Harvey, & Chia (2010) discuss how habitus may explain individual access to power elite positions (such as CEO or board director positions). First, they propose, in line with Bourdieu, that status tends to reproduce itself through habitus, and that habitus reflects a disposition, a tacit knowledge of how to “get on” – i.e., it defines a set of appropriate practices within a field. The quality of showing the “right habitus” to become an ideal candidate to business elite positions is also indicated by Hamori (2010) in her study on search firms investigating the question, “who gets headhunted – and who gets ahead?”, although without explicitly mentioning the concept of habitus. She commented, “search firms minimize the risk of a poor match by presenting well-rounded, experienced candidates with general skills and screening out less-rounded candidates whose particular skills would otherwise qualify them for

the job” (Hamori, 2010: 48). Thus, the concept of habitus makes explicit important selection criteria that are mostly tacit in present models, and it contributes to improving our understanding of director selection. While our respondents stressed the importance of context-specific competencies, the habitus signals the importance of context-generic characteristics. Our revised theoretical framework is shown in *Table 3*.

Table 3. **HABITUS AND HUMAN CAPITAL: OVERVIEW**



The second issue we find particularly intriguing in our study, and which is related to the first, are the explanations provided for the small number of women recruited to board positions. Two main arguments were formulated by our respondents: the lack of sufficient experience among women, and the difficulties women find in fitting in to a board because they are perceived as different on specific cultural and personal attributes. The latter argument is further strengthened by the tendency to evaluate candidates with reference to the departing director, and thus the tendency to replace an often male director with a candidate with similar characteristics.

Overall, we interpret our results as reflecting preferences for stability, predictability, and risk aversion in appointment decisions to corporate boards. The importance of length of experience indicates that middle-aged or older candidates are preferred. The habitus of an ideal candidate should be similar to those of the present board members. Director replacements are not guided by preferences for change; rather, the opposite is true. The compilation view on board-level human capital related to strategic issues of the firm does not define the final selection criteria among potential candidates. The preferences for a certain habitus and a risk-averse strategy both support the path dependency argument of Lynall et al. (2003) and clearly are a major explanation for the continuing low proportion of women on corporate boards. The results further indicate that the social embeddedness perspective cannot be ignored as one (among other)

explanatory factors for director selection. Finally, our findings suggest that large changes in board roles or behaviour are not likely in the near future.

Discussion Questions:

- 1) To what degree do you think recruitment to corporate boards is in line with a rational economic perspective?
- 2) How do the events described in this chapter resonate with the theories around good corporate governance?
- 3) How can recruitment practices to corporate boards contribute to better governance?

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Chapter 11

The Major Challenges in Designing Capable Nonprofit Boards

Ljiljana Erakovic & Judith McMorland

Abstract

This chapter explores major governance challenges that nonprofit organizations experience in their transition from voluntary associations to formally structured agencies. Based on a rich set of data collected from more than 40 New Zealand nonprofit organizations, we argue that developing the governance capacity and collective capability, built on adoption of best practices, diversity of ideas and experience, sound protocols and systems, and strong relationships amongst board members, between a board and the CEO, and amongst the board and the organization's stakeholders, is of key importance for an agency in order to position itself within the sector.

Key words: nonprofit organizations, governance capacity, governance capability, nonprofit boards, board-management relations, organizational life-cycle.

Introduction

Many authors have discussed the evolutionary aspect of the governance and management issues in nonprofit organizations (see, for example, Billis, 2010; Bradshaw, 2009; Minkoff and Powell, 2006). Billis (2010), among others, emphasized various steps and issues in transforming an association, which has more a voluntary character, to an agency, with all characteristics of formal organizational structure. In the later stages of organizational life-cycle when an agency becomes more dependent on external funding (especially in the form of government contracts), the organization has to demonstrate compliance with standards of service, health and safety and other employment regulations, as well as financial transparency. Organizations lose the freedoms of a purely 'voluntary' association and take on aspects of a service bureaucracy. Employment of staff, and the development of tiers of managerial responsibility, signals a

fundamental shift in nonprofit organizations from *association* to *agency* (Billis, 2010).

The transformation to an agency requires the intentional design or the introduction of systems and practices that will institutionalize standards and quality of work. Developing the organizational and governance capacity embedded in these systems is a key importance for an agency in order to position itself within the sector. The capacity building includes, among other things, adoption of best practices, understanding external issues and governmental policies, and knowledge of funding opportunities and requirements. Although much of this work in an operational sense is executed by the professional management, there is an enormous challenge for voluntary boards to understand and strategically act upon these complexities. When the board truly lets go of operational matters they step into new work at a new level. The board takes on responsibility for championing the vision of the organization over a longer time frame. This calls for strategic imagination and a strong partnership with the chief executive. A board's role is to envision a desired future, to discern the best, most effective, direction to go in, and to bring the organizational 'craft' safely through any hazards met on the way. Collectively, the board acts as the 'steersman'³⁵. Like anybody entrusted with navigation, the authority to direct must be predicated on appropriate depth of seamanship, and must earn the respect of the crew. The work of governance is quite specific: it is to steer the craft, but not to row it. The essence of governance is direction-providing and seeing the craft and crew are 'fit for purpose'.

Good governance is predicated on good management. The relationship between board and Management is an evolving one. There will be times in the early development of organization when the responsible body sits alongside rather than distanced from management. Issues of management processes and best practices are relevant when a 'governing' body operates in the form of a management committee in an association. When the responsible body employs a manager, former operational work is no longer the board's responsibility. Board members may, of course, continue to lend their skills to the organization in other capacities, but they do so as volunteers, not as governors. The governance and management capacity of the agency needs to fit the complexity of the service it is providing. Separation of management's responsibilities

³⁵ The term 'governance' comes from the Latin word gubernator – a steersman, referring to the person wielding the long rudder at the back of a galley full of rowers.

from governance accountabilities requires an equal level of capacity and capability in both bodies.

Our interest in this inquiry lies in the discussion of governance challenges that a nonprofit organization faces in its transition from an association to an agency. In our investigation we especially focused on emerging governing practices as organizations experience internal organizational changes and address changing political, social and economic contexts. We explain the qualitative difference between governance and management and discuss the importance of individual and collective capability building at board level. We argue that the board, in partnership with senior management, is responsible for the future direction of the organization and its outcomes. At this transitional stage, the work of the board is translated into action by positioning the agency within its sector, and crafting strategy to respond to changes in the environment.

Attention to accountability and governance policies has dominated the research on nonprofit governance in recent times (see for example, Carver, 1990; Carver and Oliver, 2002; Mulgan, 2000). Legislative, compliance and procedural activities should not, however, overshadow the key role of the board which is to provide direction and vision for the future. We, thus, draw attention to the board's leadership role and major transitional challenges in building sound governance and organizational leadership.

Empirical Research

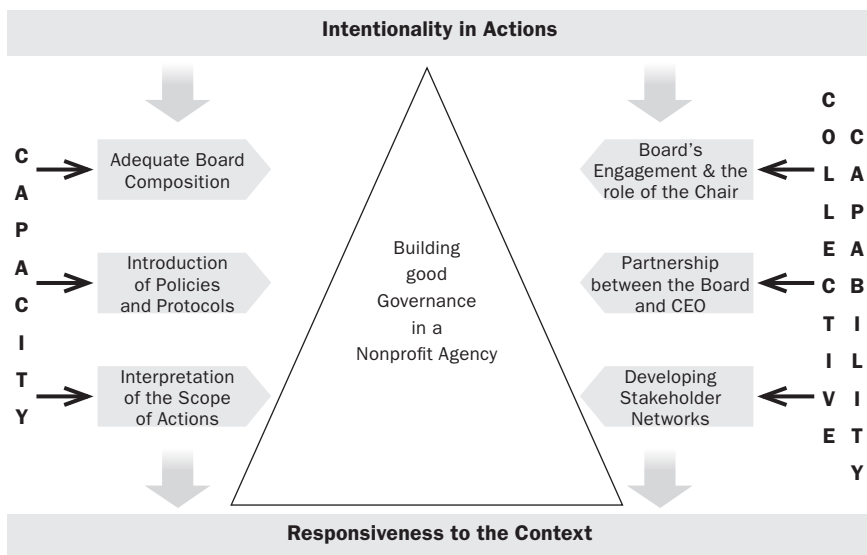
Over a four year period (2008-2012) we have conducted primary research for a major study of organizational development in a range of New Zealand nonprofit organizations. Our empirical base was extensive. We interviewed over 80 participants in 40 organizations targeting CEOs/General managers and board members/trustees in these organizations, plus a few experts in the sector. The organizations we studied predominantly belonged to the social services sector. They ranged from small autonomous organizations with revenues below NZ\$500,000 to large national bodies with revenues greater than NZ\$5M. Our case organizations were highly dependent on three major sources of income: government grants, community trusts and lotteries, and membership fees. The large organizations (agencies with revenues between NZ\$1 million and NZ\$5 million) were tapping in to more sources of income. Almost half of the research organizations had fewer than five full-time employees, and one third had more than 15 employees.

Our approach was first to interview, if possible, two or three long-standing members from each organization, who could give us the story

of their organization's development, and then to talk independently and in depth with the current CEO/GM and board members. Interviews were taped and transcribed. After reading transcripts many times and much discussion we both became very familiar with the data. This enabled us to identify recurrent themes and make comparisons, to see patterns and draw out the threads that hold organizations faithful to their mission, and to see the issues that challenged them at particular transition points. In some cases we went back to organizations for updates and further discussions. The interview data were analyzed using thematic analysis (Huberman and Miles, 2002; Wolcott, 1994). This chapter focuses on our interpretation of the major issues that voluntary governing bodies experience in designing their responses to increasing internal and external complexities.

We designed our discussion around two major attributes of good governance – capacity and collective capability. In organizational terms, capacity refers to the purpose, roles, structures, processes, and systems that constitute the organization. Governance capacity refers to the scope of action a board (or a responsible governance body) can undertake and the resources needed to deliver on its mission. Collective capability refers to the way in which people work together. However capable individuals may be at particular tasks or responsibilities, if they do not have the ability to work with others, the capability of the whole organization is compromised. Relationship capability is a shared responsibility. It can be fostered and deepened through example and careful attention to its central importance. Collective capability is an expression of the shared values that are articulated as part of the philosophy and mission of the organization.

Figure 1. **MAJOR ATTRIBUTES AND THEIR FACTORS
IN BUILDING GOOD GOVERNANCE IN A NONPROFIT AGENCY**



Capacity

We discuss the capacity of a board in terms of the organizational factors of composition, processes and protocols, and intentionality. These factors create the vehicle for governance action and provide legitimacy to the board's actions. Capacity provides the vehicle; capability determines the quality of governance expression.

Capacity as composition

Composition of the responsible body established for an association may no longer be appropriate for the level of complexity that the organization has reached as an agency. As the work of a board (and the organization) increases in complexity, there is more to take into account, more to hold in balance, greater risks to assess, and greater opportunities to explore. More time and effort is expected of board members and there is recognition that particular skills are needed which may not have been found in an earlier board composition. Composition, however, may be constrained by constitutional requirements such as membership criteria (e.g., parents, clients), regional quota and/or cultural or gender diversity criteria. A common practice is to seek a diversity of board members to provide different perspectives. The purpose of that diversity needs to be intentional.

One CEO in the Disability sector reported:

[W]e look within in our own networks for people who might be the right person for our board. We've got an absolutely amazing board; they're very clear about the work of the organization. They come from all sorts – we've got a primary school principal, sports development officer, father of a young woman who has been in our organization since year dot, he's from Inland Revenue Department. A guy from Auckland, a consultant but also a CE of a primary health organization and a young woman just graduated from university, smart young woman who experiences disability herself, and our Chair, who is a consultant working in organizational development in the nonprofit sector. So we've got a dynamic board.

The capacity of a board to absorb and embrace new members is an important indicator of organizational health. Diversity of ideas and experience enriches the capacity of boards to make sound decisions and avoid 'group think'. Many boards constitutionally require ethnic and cultural, different age ranges, and regional or consumer representations. Finding adequate ways in which these representative voices can be heard against the dominant discourse of the board is a challenge (Bradshaw and Fredette, 2011). People from diverse backgrounds need to be encouraged to participate if their contribution is to be effective. If board members do not recognize when their own cultural perspective is dominant, they can cut across the contributions of others.

A wholly member/beneficiary-base board may have the range of skills required to keep a central focus on the needs of the agencies' membership, but may not have a wider view on where or how such an agency might engage with their sector as a whole. Difficulties arise when board members are not in touch with the work the agency does. Board members cannot be effective if they bring only professional or technical skills, without also having knowledge of the sector. Board composition will therefore need to be reviewed regularly as the organization develops in complexity.

A wise board is one where individually and collectively the group can 'interrogate their own thinking' (McNiff, Lomax and Whitehead, 2003); that is, reflect on what they think and why, and understand the implications of their collective interpretation of factors for the leadership that they are called to exercise. Part of this self-awareness is to declare any conflicts of interest. This does not relate only to financial matters. It may well be the case that loyalties in another part of one's life conflict with the values or

responsibilities attached to being a member of the board. When people hold entrenched ideas that are incompatible with the purpose and aspirations of the organization (such as resistance to change, or too narrow a definition of mission) or when outside loyalties conflict with board values, the rationale for their continued participation as a board member should be addressed.

Capacity as processes and protocols – recruitment, selection and tenure

Possession of specialist skills or relevant knowledge (being a migrant, a religious leader, an accountant, a medical specialist) does not of itself guarantee that that person will add value to the board of a Migrant Service, Church Social Service Agency, Cultural Society or Aid Agency. The crucial test would be that these attributes add to both the capacity and capability of the board, enabling it to do the work that is specific to governing. How specific individuals are chosen is an important indicator of the openness and intentionality of the board to find the right people for the right times.

Ensuring the adequate processes for the recruitment, selection, induction and training of board members is an essential dimension of capacity. There is internal work that any board must do on its own behalf (separate from management) to ensure that its processes, protocols and procedures are in good order. This means not only ensuring that such processes are in place in theory, but that they are put into intentional practice and regularly reviewed.

RECRUITMENT AND SELECTION. Introduction of recruitment and selection criteria for board members may be novel practices for many boards, but such processes allow for proper identification of suitable contributors. Relevant recruitment criteria might assess individuals' ability to think strategically, to work with complexity, their willingness and availability to invest time in board work and work effectively with others. Recruitment of people for their specialist knowledge needs to be driven by strategic considerations, not expediency.

As new people are recruited into governing positions, it is important to realize that the role board members are being asked to play may not be fully understood by all. For several new appointees, we interviewed, it was difficult at the outset to understand what was required of them. Few received any proper induction or initial training, and their legal liabilities as board members or trustees were not explained. The process of gaining appropriate experience may take a while. The specific 'governing' roles in this case may be under-developed and lead to either insufficient action and/or anxiety. The capacity and capability of board members to perform is not questioned, but their potential at this emergent stage is as yet unrealized.

Every time new people are brought on board, the group needs to be reconstituted. The dynamics of the group will need to (re)settle. Task and relationship aspects of board roles need to be emphasized. The CEO of a Community development organization explained an initial recruitment process in his organization:

“We’re a bit of a seat of the pants on that one.....In the last number of years the recruitment has been somehow between [the Chairman and me]. When they’ve [new members] come on board, or thinking about coming on board, they spend time with the Chairman, and they spend time with me learning about the organization. The Chairman certainly explains to them their role. So, although they don’t have a piece of paper (it’s probably something that we should do), their role has been quite effectively explained to them. Then, I’ve introduced them to the organization and from there they’ve decided whether they do want to put their hand up to be elected or not.”

Our research results have shown the prevalence of informal processes for recruiting board members, suggesting that even with the best of intentions, old patterns of friendship and collegial affiliation can still undermine change intentions.

TENURE. Terms of tenure are usually stated in the Constitution. New strategic intentions may require revision of these terms to ensure that there is a balance between experience and new recruits. In our research, a picture emerged of considerable stability of board membership with 46% of board members serving 7-10 years. During such a period, the organization may have undergone considerable change. Potential loss of important institutional knowledge is one of the risk factors that boards need to address when thinking about succession and sustainability of the board. However, entrenchment of particular perspectives may not serve organizations going through different stages of development, despite the importance of preserving institutional memory. Sometimes a certain level of upheaval of the people in both management and governance may be necessary if the board is to have the capacity and capability to embrace change and assess the merits of various ways forward. Revisiting the history of the organization, from time to time, is an interesting exercise that helps identify earlier phases of transition and capacity/capability issues already overcome.

Capacity as a Coordinated Action

A strong coordinating factor of any governing body is commitment to the values and intentions of the agency. This means transcending individual interpretations of mission in search of a shared understanding of the 'common good'. The ability to transcend personal interest for the wider cause enables board members to work together effectively on governance issues. A single issue focus can be dysfunctional for the board working. A board member with extensive governance experience in various nonprofit organizations stressed:

It can be frustrating when you have people who have one issue that they want to achieve. So you've got your issue members who have got one thing that they've set their mind on achieving and they're not particularly interested in anything else, which again, is not really what director responsibility is about. But in the nonprofit sector I've seen that relatively frequently.

If a board is to have strategic capacity then time spent on clarifying values, exploring shared meanings, checking out interpretation of language, and exchanging ideas, will be time well invested in building the social capital of the organization. Board members' connections to each other, through the cause for which they work, provide a capacity threshold within which considerations for action, priority setting and imagination for the future can be discerned. The collective capacity to appreciate the 'insider view' and to see the whole rather than its parts is built up from the different perspectives of individual members, but is dependent on all members being able to see that they are contributors to, not individual determiners of, a collective view. The Chair of a Family social services agency explained:

I've always had a really strong sense of justice, of children being looked after, and if you've got children being looked after, you have to have care-givers who are being supported and the thing about working in that area for me is there is always hope that things will be better. So I think, no matter what skills you are calling on your board, you have to have people who have that passion. They may have it to a greater or lesser degree, but if they are not engaged with that passion, let them go somewhere else.

The skill sets that specific boards require will depend on the context in which they work. Some skills will be sector specific; others are generic to 'strategic thinking'. Requisite skills identified in the abstract constitute part of the board's capacity, but skills on their own are insufficient to create an effective governing body. There is an important dynamic interplay between

capacity and capability, between individual and collective attributes, and between task and relational behaviours. However talented or diverse the members of a board are, without the ability and will to work well together, they will not be able to maximize the emergent potential of the group or move beyond the merely functional endorsement of management activities.

Collective Capability

The full potential of governance is realized when strong relationships are forged amongst board members, between a board and the CEO, and amongst the board and the organization's stakeholders and the general public. As the responsibilities of service provision and common good advocacy become more complex, so the spectrum and nature of relationships changes. As organizational arrangements develop so the challenge grows to hold these diverse relationships in balance.

Balanced relationships are seen when leadership is shared between board and management, respective authority is exercised appropriately, and the relationships which pertain within and between board and staff are respectful and professional. Relationship development is emphasized in the fledgling stage of an organization's development, when its survival usually depends on the work of a group of passionate individuals. It becomes even more so in a more mature stage because the group charged with the responsibilities of governance is constrained by the capacity issues discussed above. Being able to work together under these circumstances requires knowledge of a 'third kind' – emergent group dynamics and relationship building. How does a group that is constituted infrequently, likely to be geographically dispersed, and composed of individuals with different experience and perspectives on mission come to be forged as a *strategic group*? How do individuals identify a role for themselves and how does such an individual interpretation contribute to the collective capability needed? These are hard questions to answer: they must be asked of individuals and the board alike, and while a heavy burden falls on the Chair of the board to manage relationship-building, responsibility for finding answers is of course shared.

Board dynamics

There is a welter of literature on group (board) dynamics and much of it focuses on increasing effectiveness and performance of tasks (see for example, Firstenberg, 2008; Forbes and Milliken, 1999; Huse, 2007; Stiles and Taylor, 2001). From our experience and research, a focus on task is not enough. Our current research points to some specific issues

of relationship building within boards which we suggest are important aspects of maintaining a healthy organization.

Board membership is an affiliation that exists over a period of time – possibly for many years. The active part of belonging to the group is not however continuous – interactions happen formally in designated board meetings (and in subsidiary sub-committee work) which happen on a monthly (or less frequent) schedule. Maintaining commitment and focus between meetings is important for the effectiveness of the board's working time together. Pre-task, post-task, and off-task phases are much longer than the actual on-task work. Between meetings is a period of latency, but it should not be a period of disengagement from board membership. Board members have personal responsibility to stay connected to the agency's work and continue to hold in intention the work of governance that it is shared. It is also a phase where much can happen in the lives of individual board members which may impact on their capacity to continue to perform. Threads of connection need to be maintained amongst members. The longer the time between meetings and activities, the more important the connectivity, the greater the importance of acknowledging any new realities of the organization, and the greater the value of preparation for the next cycle of work. The development of collective capability is a shared responsibility, but the Chair has the major burden of balancing and encouraging the process of engagement and contribution. The Chair of a leading Arts performing organization, sitting on several nonprofit and for-profit boards, explained:

As a chairman in nonprofit, you don't just lay down where the board meeting is, you really manipulate your people to get it so it's quite distinctly different in that you're not paying these people therefore you really have to work around their programs and try and get them in. And keeping the time down is half the job. ... Because it has got a habit of sliding out if you're not careful ... I think the key to a really good nonprofit is a good chairman. If you've got a good chairman generally you can put a good board together and with luck you can keep it together and the staff should feel fairly seamless.

The role of the Chair is crucial in maintaining appropriate momentum in discussion, balancing divergent opinions and approaches, allowing topics to be fairly canvassed but also pressing the decision-making process forward, always aligning decisions with mission and values. Because people are attracted to organizations where worldviews are shared and perspectives on

values and principles rarely challenged, exploring and exposing the impact of individual and collective mental models on collective decision making can only be done in the context of courageous conversations and a climate of acceptance of differences. As convener of the board, the Chair has the specific role of providing a ‘container’ for skillful, intentional dialogue and debate. A Chair who focuses only on task misses the essential work they are required to do – namely foster and call for strong, collegial working relationships amongst board members.

The Evolution of Board-CEO Relationships

Maintaining balance in relationships is an on-going commitment particularly for the Chair of the board who must engage with the CEO regularly. Together they form the bridge between management (operational work) and governance. Organizations may use a range of structural patterns for the Chair role which impact on the relationship between Chair and CEO. Some agencies have a permanent Chair with unlimited tenure, some have stated tenure, and others rotate the Chair position. Given the importance of the Chair-CEO relationship, however, each of these patterns will impact on how the people in these two positions adjust to one another, navigate the sharing of authority and expertise, and grow in themselves whilst maintaining or growing their organization.

Responsiveness to context requires active shared leadership and considerable trust by the board of the CEO, when working under political or economic duress. Part of building trust is the openness with which a CEO relates to the Chair. The long quote below, from the CEO of a large Community Centre, is a good illustration of the evolution of the CEO-Chair relationships in this organization:

[The evolution of Chair/Board and CEO relationships] is a curve that looks a bit wavy. My first Chairman was a marvelous Chairman. We were a little organization ... and he saw his role clearly, it was to drive the organization into a governing situation, not an operational management situation, which it had been in the past. So, very challenging at the beginning for me, but I was very clear on what his direction was and we were on the same wave length.... He was replaced by the one who didn't quite know where he was going and he was a bit lost. And we were going through some very challenging times...because we were in this big growth period and no staff. So he needed some guidance, and he sensibly went back to his predecessor, who was no longer on the board and got some guidance, so that helped.

But during the reign of that second Chairperson there were some meddlers on the board, and that was very challenging for him. He didn't really know how to handle them, he didn't know whether he should follow them and, well there was potential for a great rift between staff and board, huge potential at that time. And it was challenging for us all, we were all learning governance. Then the next Chairperson was somebody who had been on the board and is still on the board, he's been here nearly as long as me. And he had been treasurer in the past, and he was very hands-off, do-what-you-like kind of a person. Great to know that somebody trusted me to that point, but it was too hands-off really. So that worked, I felt endorsed by him, but it wasn't perfect. I didn't have support... And then came [John] who of course is very experienced in governance and has guided companies and organizations in that area. He was deputy Chair to the previous Chairman...and that was a big turning point for us.

This example illustrates how changing relationships between the Chair and CEO are negotiated. It shows that the process is not linear, but rather one which has ups and downs, and that the various actors can learn from each other and develop governance capability together.

During periods of stability, Board-CEO relationships become patterned and people accommodate to one another. When the time comes for transitions to the next stage, established relationships are tested by new internal and external changes. Both boards and CEO may find themselves in unknown territory. If boards lack experience and are insufficiently engaged to read the signs that signal a need for change, it will be the CEO who suggests, prods, promotes, and even dictates preparation for transition. If the CEO is insufficiently experienced to take an organization forward, it will be the board's role to make an appropriate diagnosis of what is needed for the future.

Building stakeholder networks

Knowledge of the sector needs to take into account constellations of related stakeholder interests. For some agencies, church affiliation and church politics play a big part in providing a membership or supportive constituent base, or shaping acceptable activities; for others, knowledge of where sponsorship money might be found amongst the commercial sector, or what service outreach meets the criteria of philanthropic bodies is also part of the wider picture of the dynamics of each sector segment. Dissemination of such knowledge across the board is an important

attribute of collective capability. Board members bring to their work their own knowledge of networks of relationships that can potentially be tapped into for the wider good of the organization – as a source of membership, funding, encouragement, professional advice and so on. Collectively these constitute a major strategic resource for the board as a source of influence and strategic positioning. As a resource for building social capital, influence and reputation, networks can be identified as important spheres of influence.

The positioning of an organization within its sector is a strategic decision. It determines which other players are allies or competitors, and determines the scope of action an organization can reasonably expect to service. The question of who is an ally or a competitor is made complex because of funding policies. Agencies that would naturally collaborate in, for example, the fight against child poverty, may find themselves in competition with these same organizations in competition for funding. Relative positions that organizations hold within a particular sector will consolidate or reconfigure as creative solutions to the competitive/collaborative dilemma are sought.

Many nonprofits rely heavily on government funding provided through contracts for service. An organization's history of contractual relationships can be an important factor in determining future success in contract bidding. Contracts for service are contestable and require an agency to demonstrate that it has the appropriate capacity and capability to provide the service securely. This includes adequate governance. Agencies entering into contracts must be 'competent parties', that is, having the legal status and informed capability to enter into such an agreement. This expectation, however, does not always result in the best governance practice as the CEO of a Social services agency explained:

With the rise and rise of the contractual environment we are dealing with high level statutory contracts and a lot of those have been signed off and not understood by organizations. As soon as you get into that sort of contractual environment the need for good governance becomes paramount. It's all funding driven. They [board] don't know what they are actually signing into and governance doesn't reflect that.

Over dependency on government contracts leaves an organization vulnerable to changes in government policy, but can also be a trigger to stimulate discussion about alternatives, in particularly preparing for the possibility of diversifying outputs and client/consumer groups. Chasing contracts merely for the sake of gaining access to funding has consequences

on capacity and capability and, for the board, risk and consequence management. Fiscal management of the organization and searching out of contractual opportunities is the work of management, but board members need to be able to assess the adequacy of capacity and capability within the organization to deliver contractual obligations, and the risk factors these impose, across all of the work that the agency undertakes. Such an assessment is not on the viability of separate contracts (for which the board is responsible) but for the viability of the whole organization. It is about ensuring that the organization's structure and systems are robust enough to withstand the challenges of current and future conditions.

Concluding Comments

The shift from a voluntary association to an agency marks a fundamental change in the form of the organization and its governance. As complexity grows, so does the need for new skills and new ways of thinking. We argue that the skills, knowledge and general capabilities required of the responsible governing body going forward, are not the same skills knowledge and activities that were relevant for the association. External institutional pressures (for example, contractual and accountings relationships, and legislative requirements) and internal, managerial demands for more formalized behaviour require from the board to develop adequate criteria to choose people appropriate for the new governance work and to abandon old patterns of recruitment (e.g., friends, Old Boys network, and available volunteers). Our research shows, however, that new board members are seldom adequately inducted into the workings (processes, policies and protocols) of the board, nor are their legal obligations fully explained to them. Institutionalized behaviour or 'the standard way of doing things' (Judge and Zeithaml, 1992) establishes (formal and informal) boundaries within which the board continues to operate and steer organizational development towards the stage of consolidation or stagnation.

As an agency, a nonprofit organization needs to position itself in terms of its specific intentions, concepts of strategic change, and its relationships with other players in field – be they stakeholders, public or private contributors, allies or competitors, funders or beneficiaries, and society at large. The board and the CEO/GM play pivotal roles in engaging in strategic discussions across multiple stakeholders – communities of practice, professionals in the field, related organizations, government and local authority bodies, commercial enterprises, as well as independent thinkers and visionaries. By deepening commitment to mission beyond operational

expression to creating value for the long-term future, organizations are challenged to think afresh of what lies at the heart of their strategic intent.

We further indicate that the role of Chair is crucial in forging a link between management and board. The Chair needs to provide strategic leadership and a longer term perspective on how operational tasks should express the mission of the organization. An open trusting relationship between Chair and CEO/GM provides opportunity for mentoring the manager, protection from board interference, and appropriate review of performance. The Chair also leads selection of new board members, builds capability in individual and collective board functioning and sets the climate within which decisions are made and values upheld.

Finally, our research reveals that the shift from association to agency signals the introduction of different set of relationships within and outside the organization and different sets of expectations as to outcomes. The introduction of management and formal structures ('professionalization') should not be taken as a short-hand for the imposition of a 'business model'. There are several different models of management appropriate for the nonprofit environment, and whilst management implies the introduction of systems and practices designed to bring efficiencies and effectiveness, this does not mean that 'for profit' values alone pertain.

Our study advances the understanding of governance work in nonprofit organizations by focusing on the challenges of responsiveness and intentionality in the board's functioning. We show that to meet these challenges responsible bodies need appropriate attributes of capacity and collective capability that go much deeper than focusing on the efficient and effective use of resources and setting of policies. Many organizations in our study based their understanding of governance on the work of John Carver. Our interpretation of the new work that governance is required to bring challenges some of Carver's perspectives. In particular we argue for a close partnership (rather than the traditional governance/management separation) between governing bodies and CEO/senior management as a source of generative and creative activity and direction finding. The concept of generativity as the basis for 'governance as leadership' (Chait, Ryan and Taylor, 2005) fits closely with our understanding that discernment of what to do in situations where the answers cannot easily be discovered is key to strategic thinking and collective strategic decision making. On the basis of board members' individual attachment to deep values and meanings, a board collectively provides the template and leadership for strategic decision making and future development.

Discussion Questions:

1. Has the organization developed operational systems and protocols to match innovate services and projects, and to allocate resources across the organization? Has the board discussed the match between current operations and future developments in order to 'manage' risk and consequences?
2. Are the intentionality and mission held over the longer term (3-5 years)?
3. Do the board composition and recruitment processes bring in requisite skills for strategic direction finding? Does the board recruit people with strategic thinking capabilities?
4. Does the board intentionally recruit people for governance needs? Is there a balance of sector knowledge with professional skills that add value to the board? How are the issues of representation and participation defined and agreed? Is the senior management team well-appointed and is the CEO strong strategic thinker?
5. What are the major characteristics of board-CEO relationships in the organization? What are the strengths and what are the weaknesses? Does the current relationship allow for strategic development with board championing value for the future and management according professional autonomy in operations?
6. Has the organization developed strong relationships with the key stakeholders and alliances within the sector? Does the board carefully scrutinize changing trends and develop strategies for use of wider networks to enhance reputation and sustainable relationships in particular economic and political climate?

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BIOGRAPHY

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Chapter 12

“Will You Keep An Eye On My Investment?” An Empirical Analysis of the Link Between Institutional Investors and Boards of Directors

Pascual Berrone & Dionisio Garcia-Piriz

Abstract

One of the few issues in which both institutional investors and board chairmen coincide is in the level of responsibility that corporate governance played in the financial crisis that started in 2008. Both groups agreed that corporate governance, especially in the financial sector, played a major role and is one of the main culprits of the economic crisis. This result fuels the ongoing debate regarding the level of responsibility that governance mechanisms and structures have in promoting or preventing future collapses. Good corporate governance may not provide immunity to crisis but it will almost certainly reduce vulnerability to subsequent crisis. Therefore, the design of new policies which ensure better corporate governance mechanisms seem vital to prevent future crisis. This chapter contributes to the understanding of the shape and role of such policies via an exploration of the attitudes and viewpoints of players falling into these two categories.

Introduction

The worldwide economic crisis that erupted in 2008 and deepened during recent years is looking for culprits and many are pointing at corporate governance systems as one of them. In the words of Marcello Bianchi, Chair of the OECD Steering Group on Corporate Governance, “Corporate governance failures played a very relevant role in financial crisis and in some cases where one of the causes” (Bianchi, 2009). Indeed, one issue that many attending the 2009 annual meeting of the World Economic Forum in Davos, Switzerland, could agree upon was that most corporate governance systems have not been working adequately. Moreover, the governance shortcomings contributing to the crisis are not uniquely American, with companies in many countries adding their own governance caveats to the crisis. While many complex and interdependent forces led to the current

economic crisis and corporate governance may or may not be a root cause of this downturn, it would appear to be an important contributing factor.

This situation invites us to review current governance mechanisms and call into question our conceptions and theories of effective corporate governance (Gomez-Mejia, Berrone, & Franco-Santos, 2010). And certainly, the current financial turmoil provides the ideal arena to encourage debate against the previous established models. As a result of this, it seems crucial to understand what the underpinnings of corporate governance are in order to eventually help to avoid future economic difficulties.

Agency theory has been the dominant theoretical framework in the corporate governance research and one of its basic assumptions is that the Board of Director's main purpose is to defend shareholders' interests (Johnson, Daily, & Ellstrand, 1996; Zahra & Pearce, 1989). That is, investors delegate tasks to boards which implement control mechanisms to monitor the management team, aiming to align the executives' interests with the owners' ones. As such, boards are assumed to represent investors fully. The ultimate goal of this paper is to examine the validity of this assumption.

In order to do so, we first conducted in-depth interviews and later surveyed two groups in Spain: 29 Institutional Investors (including hedge funds, pension funds, family offices and both international and national investment funds, and 28 Board Chairmen (or their representatives) from Spanish publicly traded firms. We test the level of agreement between these two groups around nine research questions related to the importance of corporate governance, its effectiveness, the level of satisfaction and influence of institutional investors, corporate social responsibilities, and future challenges for firms. Results indicate that the views of institutional investors and boards of directors barely coincide.

Our work contributes to business research and practice in different ways. First, we test one of the most fundamental assumptions of corporate governance which indicates that boards fully represent the interest of investors. While prior research (Aguilera & Jackson, 2003; Bruce, Buck, & Main, 2005; Fligstein & Freeland, 1995; Lubatkin, 2007; Lubatkin, Lane, Collin, & Very, 2007) has called for reassessments and tests of the basic assumptions of agency theory (the dominant theoretical paradigm in the field), the link between investors and boards has been largely neglected. To the best of our knowledge, this is the first empirical study that explicitly tests the extent to which the assumption that boards fully represent institutional investors is appropriate. Our results suggest that this assumption needs to be relaxed in order to better understand current corporate governance

practices. In this way, we extend agency theory. Second, the phenomenon of corporate governance has been traditionally and overwhelmingly tested in Anglo-Saxon countries, but relatively little research has been conducted outside this context. We agree with Aguilera and Jackson (2003) that corporate governance varies across countries and that the study of corporate governance would benefit from acknowledging the role of institutional and national contexts. In this vein, our empirical setting is comprised of investors and firms located in Spain and, therefore, it offers a European perspective to the field. Lastly, we contribute to the corporate governance literature by analyzing the links between institutional investors and boards of directors right after the economic crisis that started after the collapse of Lehman Brothers. Thus, our research is timely since corporate governance mechanisms have come under intense fire and criticism lately.

Theoretical Framework and Research Questions

Agency theory has been a popular framework for analyzing relationships that involve delegation from investors (the principal) to managers (the agent) in return for a fee, and has been the dominant paradigm in corporate governance research since the early 1970s (Eisenhardt, 1989; Ezzamel, 2005). In essence, agency theory proposes that when delegation is involved, conflict of interest between the parties may arise, and information asymmetry increases the possibility that agents may take advantage of principals. To prevent this from happening, principals relay on the board of directors with the obligation to ensure the actions of management are scrutinized and evaluated to curb managers' behaviours that harm owners' interests.

There are several studies in which somehow it is questioned the role of boards as trustworthy representatives of shareholders but they do not directly examine how well the boards represent the investors' interests per se. Rather, they do it indirectly by assuming for instance that director reelection or high CEO pay packages harm the interests of shareholders, although these may not be necessarily the case.

This paper examines the opinion of both shareholders (institutional investors in our case) and board chairmen around certain topics, as explained next. We focus on institutional investors given that they represent the major owners of equity in corporations around the world (Edwards & Hubbard, 2000; Hansen & Hill, 1991). We also focus on board chairmen since they are at the apex of the organization and the main representatives (and ultimate responsible) for actions of the boards.

Good Corporate Governance and its Importance

Corporate Governance is perhaps the most studied topic within the management field and literally thousands of studies have been conducted around topics such as CEO pay, board structures, and institutional owners (e.g., Gomez-Mejia & Wiseman, 1997; Johnson et al., 1996). Given that the goal of this study is to contrast the views of institutional investors and boards of directors, a reasonable starting point is to know the extent to which the importance of corporate governance is shared by these two groups.

Question 1a (Q1a). Are the views of Institutional Investors and Board Chairmen regarding the importance of corporate governance similar?

Moreover, there might be contrasting views about what constitutes good corporate governance. There seems to be a general agreement in the corporate governance domain that good corporate governance is defined as a pool of practices which are intended to secure “independence of the boards, transparency in the information, and equity in the treatment of different types of investors” (Gregory, 1998: p.6). However, despite the wealth of research on corporate governance issues, empirical evidence about whether good corporate governance produces good corporate performance is rather weak (Finkelstein, Hambrick, & Cannella, 2009; Gomez-Mejia et al., 2010; Hambrick, Werder, & Zajac, 2008). Thus, it is relevant to ask whether there is alignment between institutional investors and boards of directors regarding what they understand by good corporate governance.

Question 1b (Q1b). Are the views of Institutional Investors and Board Chairmen regarding what constitutes good corporate governance similar?

Institutional Investors Influence

Institutional investors have increased their equity stake in many companies across the world and therefore today its potential influential role in corporate governance must not be underestimated (Gillan & Starks, 2007). Prior literature suggests that the large level of assets controlled by institutions makes efficient movement in and out of stock positions increasingly difficult (Nussbaum & Dobrzynski, 1987). Institutional investors may find it difficult to sell large blocks of shares without being affected by a concurrent decline in share prices (Baysinger, Kosnik, & Turk, 1991; Hansen & Hill, 1991). As a result, institutional investors “have a tendency to become involved in corporate control when results do not live up to expectations” (Graves & Waddock, 1990).

In contrast, some scholars (e.g., Heard, 1987) argued that these institutional owners are quick to follow the “Wall Street” rule, selling

their stock when dissatisfied with management instead of attempting to influence governance mechanisms or exercise control over the firms in their portfolio..

Given these contrasting positions, the following questions are relevant.

Question 2a (Q2a). To what extent can Institutional Investors influence the governance structure of firms?

Question 2b (Q2b). Is the level of influence exerted by Institutional Investors similar to the level perceived by Board Chairmen?

Institutional investors can influence boards through different mechanisms, with a goal of improving corporate performance. One is the use of formal channels such as introducing proxy proposals (Roy, 1999). Alternatively, institutional investors can influence boards by using informal mechanism, trying to negotiate with boards and management on a private basis (Byrne, 1999; Pellet, 1998). This way of intervention may provide a better way of effectively handling discontent over certain issues (Bainbridge, 2005).

Therefore, it is relevant to ask what is the preferred mechanism by institutional investors to communicate (and potentially influence) the board of directors.

Question 2c (Q2c). Do institutional investors prefer informal communication or do they favor formal mechanisms?

Institutional Investors Satisfaction

Previous research indicates that shareholder activism positively correlates with the level of institutional ownership (Carleton et al., 1998). It might also well be the case that the level of influence of institutional investors is inversely related to the level of satisfaction of the board performance. That is, if institutional investors are pleased with the way boards manage the firm, they will have lower need or intention to intervene. Therefore, we ask institutional investors about their satisfaction level.

Question 3 (Q3). Are Institutional Investors satisfied regarding the board performance?

Corporate Social Responsibility

Current trends call for moving away from the traditional hard-core economic perspective that sees social engagement as a diversion of business resources from their proper use (Friedman, 1970) to one that recognizes activities that consider the interests of multiple constituencies, such as employees, customers, communities, governmental officials, and environment groups. Therefore, Corporate Social Responsibility (CSR) is increasingly at the forefront of the corporate agenda. Yet, the corporate governance research has traditionally concerned itself overwhelmingly

with financial performance (Barkema & Gomez-Mejia, 1998; Gomez-Mejia & Wiseman, 1997), ignoring other non-financial aspects. And while the corporate governance and CSR literatures are abundant, they have largely grown in parallel. Only recently have scholars started to analyze the intersection between CSR and Corporate Governance issues (Berrone & Gomez-Mejia, 2009a; Coombs & Gilley, 2005; Walls, Berrone, & Phan, in press). Unfortunately, available studies do not provide definitive evidence to whether firms reward or punish social responsible strategies and what combination of governance mechanisms promotes corporate social behaviours. A similar picture appears when looking at institutional investors. Some studies have shown that institutional investors neither penalize nor reward socially responsible practices (Graves & Waddock, 1994). And the argument for these results is that social actions are believed to show low or perhaps even a negative rate of return (Margolis & Walsh, 2003). Given this uncertainty about the impact of CSR on economic performance, it is not clear either whether boards would subscribe such actions. However, recent research has suggested that institutional investors tend to be associated with socially responsible practices (Johnson & Greening, 1999; Neubaum & Zahra, 2006). The underlying assumption of this view is that social actions improve corporate image and reputation, create intangible assets, and positively influence long-term organizational survival.

Given these two contrasting views, it is worth asking the following:

Question 4 (Q4). Are Institutional Investors interested in Corporate Social Responsibility in the same way Board Chairmen are?

Current Crisis and Future Challenges

Current economic crisis has sparked heated debate both in academia and in the practitioners' arena and many are pointing at corporate governance as the major culprit (Berrone, 2008; Narayanan, Ferri, & Brem, 2009; Walsh, 2008). In a Wall Street Journal article, under the subheading "Where were the boards?" (George, 2008), John Schnatter commented that "Boards of directors set the guidelines and compensation levels, and in the end are ultimately responsible for the performance of their CEOs and companies. They have a clear-cut fiduciary responsibility to provide oversight". In tandem, political leaders around the world the publicly outcry about excessive compensation packages for top executives and explicit caps were established after the financial collapse in many countries.

However, some voices indicate that corporate governance is simply a scapegoat. In a recent panel discussion titled "Responsibility and the

Financial Crisis of 2008” held at the Wharton Business School, professor Diana C. Robertson, “Do we have sufficient consistent empirical evidence to suggest that executive pay packages led to excessive risk-taking, as has been alleged? Would we still have a financial crisis if the pay schemes had been different? It is difficult to say” (Robertson, 2009).

Our study provides the perfect setting to ask main players in corporate governance their views about the responsibility of corporate actions in current economic crisis.

Question 5a (Q5a). Do Institutional Investors and Board Chairmen agree on the level of responsibility that corporate governance has had in the current financial crisis?

It is commonly said that the future business world would not look the same as before the crisis began. As Warren Buffet once noted: “It’s only when the tide goes out that you learn who’s been swimming naked” (Campbell & Sinclair, 2009). Sense of responsibility towards this crisis may differ (as per Q5a) and thus the future structure of corporate governance. As a result, different actor’s future goals and challenges will help determine whether improvements take place or not. If taken, to understand the nature of those changes seems crucial as it will determine if it impacts in the short run or in a long term view.

Question 5b (Q5b). Do institutional investors and board chairmen agree on what are the major future challenges for companies?

Methods

Sample and Data Collection

This study analyses shareholders and firms located in Spain.. Given that institutional investors tend to allocate their investment in publicly traded firms, we surveyed these types of companies. We also focused on board chairmen since they are the ultimate representative of a central decision-making body.

The sample of Institutional Investors was selected from the largest 40 investors located in Spain. We surveyed and conducted in-depth interviews with 29 Institutional Investors, given a response rate of 72.5%. These investors represented about 40% of the Spanish equity market's total trading volume as of the 31st. of March 2009. These included hedge funds, pension funds, family offices and both international and national investment funds. This first survey was conducted between January and March, 2009.

We also surveyed a sample of 28 Board Chairmen from Spanish publicly traded firms. The starting point was the 35 most liquid Spanish stocks traded (i.e., those that belong to IBEX 35, the benchmark stock market index of the Bolsa de Madrid, Spain's principal stock exchange) plus another 35 companies traded in the Madrid Stock Exchange General Index. We managed to survey 28 chairmen, given a response rate of 40%. Out of the final sample, about 46% of respondents belonged to the Stock Index IBEX 35. This second survey was conducted between June and August, 2009.

To gather information regarding the different research questions, we developed two questionnaires, one for institutional investors and other for board chairmen. In order to develop these questionnaires, we partnered with the consultancy firm Russell Reynolds Associates (RRA), which specializes in corporate governance issues. This partnership was particularly constructive for two major reasons. First, it facilitated access to respondents. Second, it allowed us to interact with professionals in the field, which proved to be useful in using proper language in the survey, avoiding unnecessary academy jargon (Lawrence, 1992). Third, engaging practitioners as partners allows analyzing problem-oriented phenomena (Amabile et al., 2001), aligning our interests with more practice-relevant research, without sacrificing rigor (Gulati, 2007).

The process of designing the questionnaires consisted of two stages. The first one included an extended literature review, wherein we analyzed previous studies in the field. The initial questionnaire took into account results of this literature review, as well as discussions with experts from RRA. The second stage comprised five meetings with institutional investors and another five meetings with board chairmen, taking the draft questionnaire as the guide. The aim of pilot interviews was to ensure that items selected are accurately understood and that they adapted to the common practice in the field. Interviews helped to modify some items and incorporate new ones in collaboration with the targeted public. Final version of the questionnaires included 5-point Likert-type questions.

After developing the questionnaires, two senior partners from RRA were in charge of conducting the questionnaires, which were completed through personal interviews. Personal interviews questionnaires are superior compared to mail or phone interviews since they allow clarifications if needed and are more effective in securing all answers (Sekaran & Bougie, 2010). Also, it is appropriate when the survey has both closed and open questions like in our case.

Estimation Methods

Given that our goal is to compare views and opinions between two groups (institutional investors and board chairmen), we needed to test the statistical significance of the difference means between the two samples. We conducted this statistical test via a t-student test for independent sample (Wooldridge, 2000). Given that group variances are unknown and t-test calculation vary depending on whether variances are equal or not, we first tested for homogeneity of variances (homoscedasticity) using the Levene test. If the Levene test indicated that group variances were not different, we used the t-statistic. On the other hand, if the Levene test indicated that variances were different, we used Welch's t-test, which is an adaptation of Student's t-test intended for use with two samples having unequal variances.

On occasion, variables do not show a normal distribution, or the samples taken are so small that one cannot tell whether they are part of a normal distribution or not. In those cases, using the t-test to tell if there is a significant difference between samples is not appropriate. The nonparametric Mann-Whitney U-test can be alternatively used in as it makes no assumption about the distribution of the data and can be used for very small samples. See Appendix.

Results

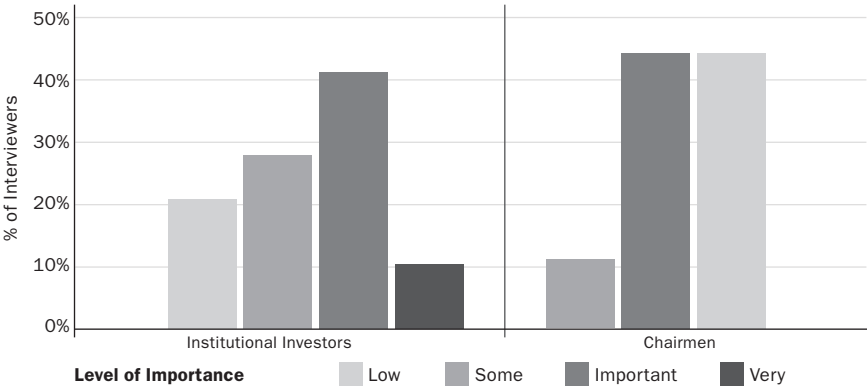
Table 1 reports descriptive statistics and mean comparisons of two sample groups (Institutional Investors and Board Chairmen) for the variables used in this study.

Table 1 – DESCRIPTIVE STATISTICS AND MEAN COMPARISONS

Variable	Mean		Standard deviation		Sample		T - Student	Mann Whitney U
	Institutional Investors	Board Chairmen	Institutional Investors	Board Chairmen	Institutional Investors	Board Chairmen		
Q1a. Corporate Governance Matters	3.41	4.33	0.95	0.68	29	27	$p < .001$	$p < .00$
Q1b. What constitutes good Corporate Governance								
Independency of directors	3.69	3.11	1.11	1.19	29	27	$p < .10$	$p < .061$
Specialized committees	3.25	3.62	1.17	1.06	28	26	NS	NS
Separation of CEO / Chairman	3.66	4.61	1.34	0.57	29	29	$p < .01$	$p < .002$
Formal evaluation of Board's activities	3.18	4.97	0.98	0.50	28	28	$p < .001$	$p < .00$
Executive pay alignment with firm's goals	4.50	3.93	0.88	0.92	28	27	$p < .05$	$p < .005$
Transparency of information	4.82	3.78	0.39	0.80	28	27	$p < .001$	$p < .00$
Fair / equal treatment of shareholders	4.64	3.74	0.73	1.23	28	27	$p < .01$	$p < .002$
Systematic rotation of directors	2.70	4.14	0.95	0.97	27	28	$p < .001$	$p < .00$
Q2a. Level of Influence in the Governance Structure of Firms								
Board Chairman	1.55	-	1.12	-	29	-	-	-
Board members	1.59	-	1.09	-	29	-	-	-
Chief Executive Officer	1.62	-	1.01	-	29	-	-	-
Other senior executives	1.45	-	0.87	-	29	-	-	-
Q2b. Level of Influence Exerted by Institutional Investors and Perceived by Chairman	1.55	2.25	0.96	1.04	29	28	$p < .05$	$p < .006$
Q3. Level of Satisfaction with Board's delegation	3.10	3.82	1.08	1.01	29	27	$p < .05$	$p < .048$
Q4. Level of interest in Corporate Social Responsibility	3.14	4.36	1.08	0.73	29	28	$p < .001$	$p < .00$
Q5a. Degree of responsibility of Corporate Governance for financial crisis	3.96	3.85	1.23	0.92	28	26	NS	NS

To test Q1a, we asked interviewees to assess the importance of corporate governance. Data collected suggest board chairmen assign greater importance to corporate governance than institutional investors. Moreover, responses by institutional investors show greater dispersion than board chairmen, as reflected by *Figure 1*.

Figure 1 – DOES CORPORATE GOVERNANCE MATTER?



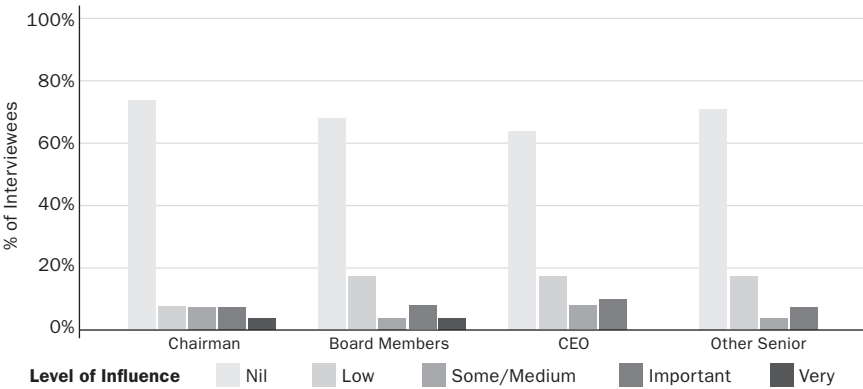
To test Q1b, we requested interviewees to grade the level of importance of some corporate governance practices in order to establish whether they consider them as good practices or not. Our empirical study indicates that institutional investors and board chairmen have different opinions in regards to practices such as: the separation of powers between the Chief Executive Officer and Chairman, information transparency, equal treatment of shareholders, aligning executive’s pay with the goals of the firm, independency of directors, formally evaluating boards activities and systematically rotating directors.

Table 1 depicts discrepancies in all of the corporate governance issues tested, except in the establishment of specialized committees, category in which both the t-student mean comparison and the Mann – Whitney U test provide evidence that means are not significantly different. Results suggest for instance, that institutional investors assign a bigger importance in assuring the transparency of information, an equal treatment of shareholders and an alignment of executive pay towards the firm’s goals than Chairmen do. All of these categories are considered on average as greatly important for institutional investors. On the other hand, Chairmen responses indicate a greater concern in guaranteeing a formal evaluation

of Board’s activities, in separating functions between the Chief Executive Officer and the Board Chairman and in assuring a systematic rotation of directors. Finally, although our study only suggests that there is a marginally significant difference of views in regards to the independency of directors, it is institutional investors who assign a greater importance to this issue.

Figure 2 – **CAN INSTITUTIONAL INVESTORS EXERT ANY INFLUENCE ON THE GOVERNANCE STRUCTURE OF FIRMS?**

To test Q2a, we asked institutional investors to grade their level of influence when composing the governance structure of firms. *Figure 2* determines that institutional investors believe that they are unable to barely influence on the composition of the governance structure of a firm. Data indicate that most of the institutional investors consider to have no influence in the decision making.

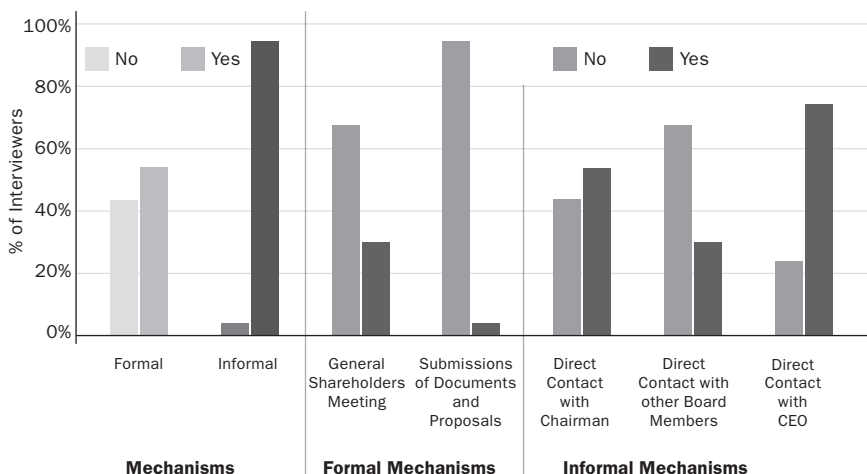


To test Q2b, we asked to Chairmen about the level of influence that they perceived institutional investors exerted over the firm. . Although still considering being low, Chairmen perceive that institutional investors exert a slightly higher influence (“low – some influence”) than the one believed to be exerted by institutional investors (“nil – low influence”).

To test Q2c, we requested institutional investors to reply whether they used formal or informal mechanisms of communication in their relationship with the firm. Figure 3 depicts responses and suggests that most Spanish institutional investors prefer to communicate with firms on an informal basis. Additionally, most institutional investors prefer to directly contact with the Board Chairman or with the Chief Executive Officer, rather than

following the formal procedures such as raising an issue in the general shareholders meeting or submitting documents and proposals to the board of directors.

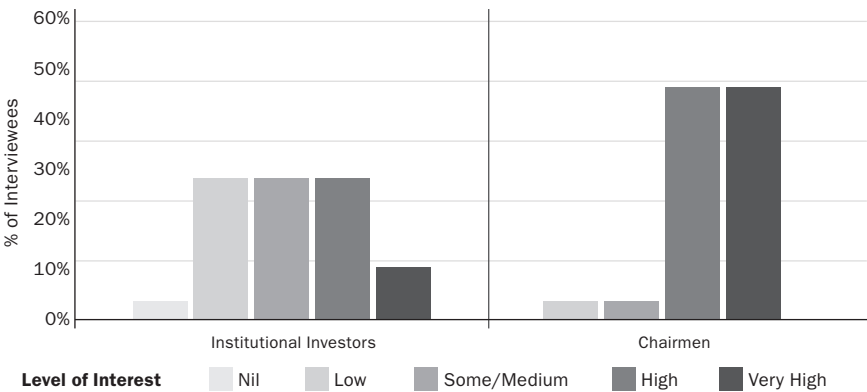
Figure 3 – WHAT MECHANISMS OF COMMUNICATION DO INSTITUTIONAL INVESTORS USE?



To test Q3, we asked institutional investors about their degree of satisfaction in regards to the task delegation of the Board of Directors. Additionally we requested Chairmen to determine the level of satisfaction that they perceived institutional investors have.. While institutional investors have “some satisfaction”, Chairmen perceive that they are actually “satisfied” with the Board’s performance in delegated tasks.

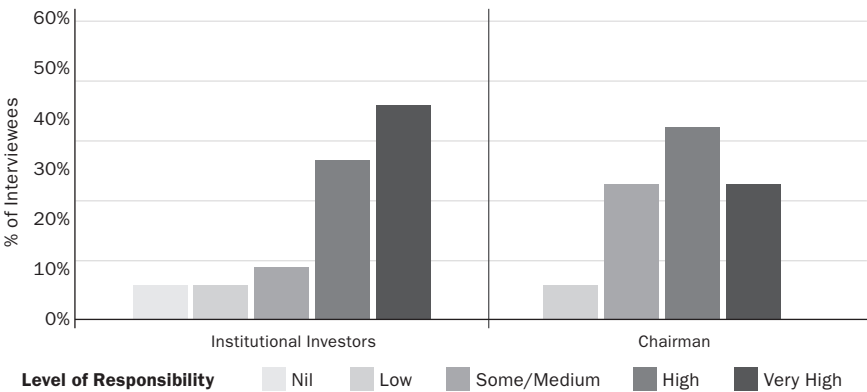
To test Q4, we requested both institutional investors and chairmen to assess the degree of importance that Corporate Social Responsibility should hold in the firm. While Chairmen consider Corporate Social Responsibility to have an “important or great importance” role, institutional investors only give “some importance or importance” to it.

Figure 4 – ARE INSTITUTIONAL INVESTORS AND BOARD CHAIRMAN INTERESTED IN CORPORATE SOCIAL RESPONSIBILITY



To test Q5a, we asked both institutional investors and chairman to grade the level of responsibility that in their opinion Corporate Governance has had in today’s financial crisis. Data from Table 1 reflect an agreement in their views: both assign “some important or an important” degree of responsibility of Corporate Governance for the financial crisis. In this case, Figure 5 shows a lower mean dispersion of responses.

Figure 5 – WHAT LEVEL OF RESPONSIBILITY DOES CORPORATE GOVERNANCE HAVE FOR THE FINANCIAL CRISIS?



To test Q5b, we decided to make an open question to the interviewees as we considered it to be extremely difficult to a priori establish a list of future challenges. In those terms, we collected and classified responses that were repeatedly answered by a group.

Institutional investors considered as future challenges the following: (1) Guaranteeing the board members independency, (2) Professionalize in a larger degree the status of board members, (3) Assuring a better risk management and (4) Protecting minor shareholders. On other hand, Chairmen claimed the following issues to be the major challenges firms faced: (1) Strengthen the firm's position within the market and its strategic vision, (2) Improve the relationship with shareholders, (3) Promote a fair and equal treatment of shareholders, (4) Increase gender diversity within the board and (5) Promote a global projection of the firm.

Discussion and Conclusions

In this paper, we examined the link between institutional investors and boards of directors. We showed empirical evidence from Spanish publicly traded companies about aspects in which institutional investors and boards of directors are in synchronization and those in which they are not. In this way, this study pretends to shed light towards a better understanding of corporate governance which, in turn, will permit create more efficient mechanisms to secure the long term strategic mission of firms and of course, will help minimize the impact of future crises. As such, this paper has implications for a variety of audiences.

Implications for Research

Agency theory has come under intense fire in the management literature on grounds that its assumptions are too restrictive (Aguilera & Jackson, 2003; Bruce et al., 2005; Fligstein & Freeland, 1995; Lubatkin, 2007; Lubatkin et al., 2007). While prior research has examined some of the agency assumptions such as the risk appetite of agents (e.g., Wiseman & Gomez-Mejia, 1998) or the homogeneity across investors (e.g., Hoskisson, Hitt, Johnson, & Grossman, 2002), little is known about the linkages about investors and boards. These relations have been indirectly studied at best (e.g. by focusing on the link between board composition and firm performance (see summary meta-analyses by Dalton, Daily, Ellstrand, & Johnson, 1998).

Noticeably absent from much of this research, however, is the explicit recognition that the views of a given investor and the board may vary. While the traditional ownership and control framework (Jensen & Meckling, 1976) is often used in corporate governance research, which includes shareholders (specifically institutional investors), boards of directors, and management, prior studies have only analyzed the link between boards and executives (e.g., Boyd, 1994; Tosi & Gomez-Mejia, 1989) and more

recently the relation between shareholder types and management (e.g., David, Kochhar, & Levitas, 1998; Hartzell & Starks, 2003). Yet, the link between investors and boards is often neglected and poorly understood. This paper fills this gap since it is a direct assessment on the alignment of opinion that exists between institutional investors and board chairmen. Overall, our study suggests that the agency assumption that boards fully represent the interest of shareholders is not valid. As such, it contributes the growing literature that is consistently looking more closely at institutional owners, investigating their impact on a variety of corporate activities (see Brandes, Goranova, & Hall, 2008).

Our results indicate that both groups have important discrepancies about what constitute good corporate governance. They only align their views in regards to the importance of adopting specialized committees. However, while institutional investors tend to provide higher importance to executive pay alignment with the firm's goals, transparency of information and uniform treatment of shareholders, board chairmen highlight the importance of separating the function of CEO and chairman, the formal evaluation of board's activities and the systematic rotation of directors. Interestingly enough, more than a third of companies interviewed had CEO duality and only a few rotated their board members in a systematic manner. Together, this suggests that there are important differences between what boards say they do and what they actually do, confirming prior studies about the board symbolic actions in corporate governance related practices (Westphal & Zajac, 1994, 1998).

This study also indicates that institutional investors have very limited influence in shaping boards of directors or top management team. One plausible explanation steaming for our data is that they exert little influence because they are satisfied and thus there is no need to interfere. The question is then: what do institutional investors do if they are dissatisfied? Clearly, institutional investors in Spain do not engage in public activism (e.g., with proxy proposals) as they prefer to intervene on a private basis through informal channels. Moreover, as a result of our interviews, many institutional investors indicated that they prefer to sell their stake in a firm if they are dissatisfied (although this issue was not formally asked in our questionnaires). If this is the case, it implicitly suggests that the cost of the "Wall Street Rule" (i.e., selling large stakes) is lower than the cost of influencing for a change in the governance structure of firms. An alternative explanation is that even when investor attempt to influence governance structure, incumbent board members are powerful enough

to disregard such efforts. Regardless voluntary or imposed, institutional investors exert low levels of influence and future research should focus on understanding the underlying reasons.

A surprising finding is the significant difference between investors and chairmen in their view about corporate social responsibility (CSR). Institutional investors tend to assign significantly lower importance to CSR than board chairmen. These results contradict prior studies (Johnson & Greening, 1999; Neubaum & Zahra, 2006) that suggest that institutional investors favor social practices and call into questions their long-term view these investors have regarding social issues.

Implications for Practitioners and Policy Makers

The relative lower importance that institutional investors assign to corporate governance issues compared to that of board chairmen should not be interpreted as corporate governance issues are not important for this type of shareholders. In fact, many of the future challenges institutional investors indicated refer to enhancement of corporate governance in companies, including aspects such as guaranteeing directors independency, professionalizing board member status or protecting minor shareholders. On the other hand, chairmen highlighted promoting a fair and equal treatment of shareholders, strengthening the position of the firm within the market, increasing gender diversity in the board and strengthening its strategic vision as the main challenges ahead. In short, institutional investors tend to favor corporate governance issues and aspects that secure short-term profitability while boards tend to favor long-term and strategic elements.

Many have call for reforms after the corporate scandals of recent years. However, it is not clear what directions should these reforms adopt. While the emphasis of many practitioners seems to be on the modification of pay schemes established in the pre-crisis, most likely all corporate governance mechanisms may need to be under overhaul. Yet, given the numerous differences that exist among all relevant actors regarding the relative importance of corporate governance issues, we suggest for these reforms not to take place until common grounds between shareholders and corporate bodies are reached. A clear understanding about what is truly relevant, the proper mechanisms and structures, and a greater agreement are needed to make these reforms successful. From our study we can deduce some “straightforward and easy” to implement actions.

Aligning executive pay with the firms’ long term goals seems today to be at the top of the corporate agenda. Shareholders (principals) decide to delegate responsibilities to management in exchange for a fee or added

value creation. However, today's executive pay schemes have not been working properly. In this context, institutional investors have much to say and most importantly to decide. In this regards, Spanish institutional investors consider as one of the priorities and as one of the most important best practices to modify and align current bonus schemes towards the strategic objectives of firms.

It also seems odd to find out that most Chairmen surveyed believe the separation between of CEO and Chairman roles to be extremely important and yet in many cases they held by the same person. If Chairmen, considered the major actors of this duality, as well as the most appropriate and legitimate people to express their opinions regarding this issue, consider so, then why actually does it not occur? Are internal pressures (management) preventing this change? Is it the company's internal statute rigidity to be blamed for? Perhaps it needs to be formally promoted by national and multilateral organizations. At least from the views of Spanish Chairmen, there is a call for a formal separation of CEO and Chairman roles. In 2009, the European Commission has proposed as a part of its "new initiatives in response to the financial crisis" a stronger involvement and participation of institutional investors in corporate governance issues like directors' remuneration. Our study indicates that this is currently unlikely to happen given the limited influence that institutional investors have on corporate structures. This suggests that the European Commission should formally empower shareholders as a means of influencing board of directors. In this way, increasing their levels of influence would probably imply a greater independency of boards and therefore an enhancement of their decision making.

Interestingly, one of the few issues in which both institutional investors and board chairmen coincide is in the level of responsibility that corporate governance played in the financial crisis that started in 2008. Both groups agreed that corporate governance, especially in the financial sector, played a major role and is one of the main culprits of the economic crisis. This result fuels the ongoing debate regarding the level of responsibility that governance mechanisms and structures have in promoting or preventing future collapses. While it is yet to be decided whether or not poor corporate governance caused the crisis, it appears that will almost certainly impede decisive recovery. In this regard, good corporate governance may not provide immunity to crisis but it will almost certainly reduce vulnerability to subsequent crisis. Therefore, the design of new policies which ensure better corporate governance mechanisms seem vital to prevent future crisis.

Questions

1. Why are owners' interests expected to be aligned to those of the boards? What is the rationale provided by agency theory?
2. What explains the divergence of interest between owners and the board of directors?
3. What consequences can flow from divergent interests between owners and boards of directors?
4. What can be done to close the gap between owners and boards?

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Chapter 13

Strategy and The Board: A Division of Labour

James Lockhart

Abstract

The five step strategic management process through which corporate strategy is developed, implemented and subsequently controlled has been observed as a division of labour between boards and management. At one extreme boards have been observed to rubber stamp proposals from management while at the other they have been observed to be the catalyst for the development of corporate strategy. The results from black box research (Edlin, 2007; Martyn, 2008; Peebles, 2010) support this division of labour. Where the responsibility for business performance is held by the board they have an explicit ownership of the strategic management process. The discussion of the division of labour presented in this Chapter, using the strategic management process as task allocation, also overcomes Tricker's (1993) reflection that "organizations [were observed to have] peaked at the CEO" (p. 1). The board's responsibility for specific functions of corporate strategic management is promoted. Various contributions to the argument are identified and explored in some detail, including corporate examples from New Zealand and Australia.

Introduction

One of the major difficulties confronting the understanding of corporate and institutional governance is the uncertain relationship between the board and both current and subsequent performance. Increasingly boards are being held responsible for organizational performance, not only by the business's shareholders but also by stakeholders in various representative roles such as Greenpeace on behalf of the biophysical environment or the Financial Markets Authority in New Zealand on behalf of depositors. Yet the relationship between boards and performance is still far from clear. Determining the source, or sources, of causality between boards and organizational outcomes is even more problematic. Despite the considerable

effort by the global research community to identify relationships and establish causality between various input and output variables we actually know little about effective governance and its contribution to subsequent performance.

Current texts on strategic management (e.g., Grant et al., 2011; Johnson, Whittington & Scholes, 2011; Wheelen & Hunger, 2010) ignore the organizational context within which corporate strategy is developed, implemented and evaluated. The relationship between the board and management is all but ignored; the contribution from the board to the process of corporate strategy is seldom recognised and the CEO is promoted as a mythical god-like deity (Khurana, 2002; Rosenzweig, 2007). To be fair, this view appears to be largely the result of the dominant US mixed-board model: one where the CEO and Chair is often the same person (duality). In this environment the functions of the board, as opposed to those of management, are difficult to identify. One of the roles of the independent directors in these circumstances is to provide the necessary balance between governance and management.

The recent shift in accountability for organizational performance from management to the board, especially by shareholders, and the increasing compliance demands being placed on boards, means that the board-management nexus can no longer be ignored. Corporate strategic management is where that nexus, as it relates to the creation of performance, appears to take place. Consequently, if boards are to be responsible for an organization's performance, and held responsible by various third parties, then that outcome should reflect their contribution - or lack thereof - to corporate strategy. Importantly, the board's contribution to corporate strategy is delivered through the broader strategic management process. The aim of this Chapter is to explore the board management nexus as it relates to the development and achievement of corporate strategy. The normative proposition offered is one of a division of labour between the board on one hand and management on the other. Consideration of strategic management as a division of labour between boards and management assists in determining not only what boards do, but also what they should do. This view has significant implications on board responsibilities and the accountability of business performance.

Henri Fayol (1916/1949) was the first to formally recognise the functions of management. In the context of strategic management the functions are typically better recognised as the establishment of direction (Bart & Baetz, 2001; Campbell & Yeung, 1991; Collins & Porras, 1994; David, 1989; Hamel

& Prahalad, 1989, 1994; Pearce & David, 1987); scanning the environment (external and internal); establishing strategy, implementation; and, evaluation and control of the outcome (and process). The suggestion being offered here is that in all boardrooms there is a simple division of labour, itself motivated by numerous forces, especially power (Kim, Pinkley & Fragale, 2005), between the board and management for the conduct and completion of each of these functions. It is not the intention of this Chapter to explore these forces here.

As governance activity becomes more formal, and separation of board and management actors more complete, that division of labour needs to be more explicit – and visible. The paradox observed is that *best practice* recommendations, such as those published by the Institute of Directors in New Zealand (2012), currently fail to recognise the division of labour between management and the board as does the leading text on the subject (e.g., Monks & Minow, 2011). Someone has to do corporate strategy but where do (and should) responsibilities lie?

Theoretical Contributions

The traditional practice of governance is largely related to the need for compliance. In part, the compliance regime is a response to the supposed agency problem (Jensen & Meckling, 1976) created by the separation of wealth (Berle & Means, 1932) and the subsequent need to control management. The discourse of governance largely reinforces the compliance motivated distant relationship between the board and the organization itself - implicit in Llewellyn's (1931) prescient treatment of contracts. However, this atmosphere is at odds with that prescribed by both Pound (1995) and Sonnenfeld (2002) who call for a committed and engaged board to govern the corporation: phenomena often observed in exemplar case study black-box research. More typically there is a somewhat distant relationship between the board and management, as is evident in power over agenda setting (Peebles, 2010).

However, not one but two phenomena are postulated to evolve from the separation of the provision and control of wealth. The first, discussed above, is agency (Jensen & Meckling, 1976). The second phenomenon is the ensuing confusion between the two groups now supposedly responsible for organizational success: the board on one hand and management on the other. Attempts to assign distinct responsibilities to the board began in 1966 with the publication of by the American Management Association (Kristie, 1997) and have continued (American Law Institute, 1992) ever

since. These lists of responsibilities are now widely accepted, being endorsed by Hilmer (1998) and KPMG (2001) in the context of Australian and New Zealand business respectively. However, in contrast to these lists of responsibilities is the argument (Cochran & Wartick, 1994; Taylor, Chait & Holland, 1996) that the board's contribution is strategic and the focus of governance external whereas management's focus is internal. This latter argument is summed up as governance being "strategy orientated whereas management is task orientated" (Cochran & Wartick, p. 10). Unfortunately, this argument also suffers from being too narrow. It incorrectly assumes that internal focus or activity is something less than strategic, and not a board role, which is a marked contrast to more recent understandings of organizational performance (Collins & Clarke, 2003). However, regardless of the source of list of directors' duties they are largely compliance related and have ignored strategy to date. The United Kingdom's Companies Act 2006, s. 172 provides a notable exception to this observation where directors' responsibilities have now been extended to long term company success.

Someone has to *do* strategy. If boards are to be held responsible for performance then surely they need to select and, better still, shape the organization's strategy. Observations of practice suggest that there is a division of labour between the board and management with respect to strategy and, importantly, the strategic management process. But, it would be naïve to suggest that this division of labour is constant, as recent observations among New Zealand's state-owned and partially-owned boards confirms. The full gambit of Wheelen and Hunger's (2002) rubric of board involvement in strategic management (refer to Figure 1) can be observed, which may partly explain the variance reported in empirical studies (e.g., Ingley & Van der Walt, 2001).

In all but totally non-executive boards elements of dual roles must exist, in which case the functions of governance, mooted as being strategic, and management (task/operational) may not follow the unambiguous division of labour being promoted here. Therefore, visibility of activities undertaken by those responsible for governance and those responsible for management will be masked in situations such as mixed boards, or family companies where roles and responsibilities are not well defined or discrete. In fact, most small-to-medium sized enterprises, and all but the largest - and listed - family companies will exhibit such masking. This is not to suggest that the roles of those assigned the responsibility for governance and those assigned the responsibility for management necessarily change, it is more that such change is simply difficult to observe. For example,

management (notably corporate strategy) and thought leadership to chance. The absence of a broader contextual process for strategy can be overcome through the application of strategic management. No longer then are the functions of governance bullet-pointed as lists. A well-informed division of labour between governance and management should be agreed consensually between them both (with potential for involvement from other stakeholders and shareholders as owners). However, there remains the ambiguity of the contextual environment that has plagued strategists and the emerging body of governance scholars for the last few decades. Irrespective of the division of labour between governance and management the creation of an appropriate external operating environment (Hamel & Prahalad, 1994; Hamel, 2001) has to remain one of the critical objectives and outcomes of any organization. The board's role in the development of strategy has recently been discussed (e.g., Huse, 2007; Pugliese & Wenstop, 2007), yet the broader strategic management process (within which strategy nests) has been ignored from that debate.

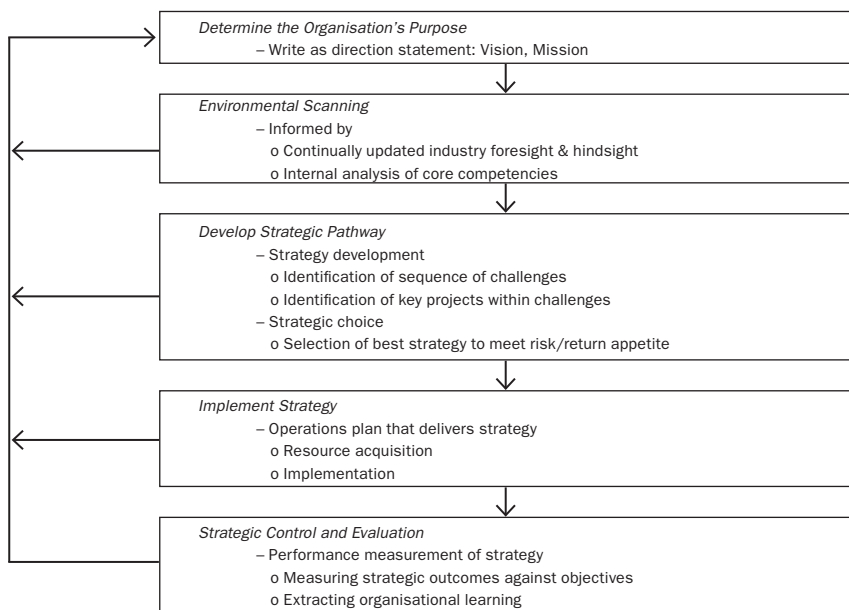
Strategic Management

Strategy is a part, albeit an important part, of the strategic management process (refer Figure 2). Strategic management is the process that operationalises and measures the effectiveness of strategy. Just like strategy and purpose (vision), the terms strategy and strategic management should not be used interchangeably as that only serves to confuse desired action with the process of designing, implementing and measuring that action. Nor should strategic planning be confused with these constructs; strategy (Step Three) is about getting to the future; strategic planning is the process used to develop that strategy (Steps Two though Three), while strategic management, which is often neglected, is the complete process of setting purpose, developing strategic plans, implementing those plans (Step Four), and then measuring the outcomes of that activity at a strategic level (Step Five). Strategic management is the process used by an organization to determine purpose, formulate strategy, and then embed that strategy into the broader process of management, as depicted in Figure 2. Importantly, strategy does not exist, certainly not in any meaningful or effective manner, without the broader framework of purpose, implementation and control.

The strategic management process is typically depicted as either being stepwise and deliberate (e.g., Wheelen & Hunger, 2002) or being the interaction between strategic position, strategic choices and strategy in action (e.g., Johnson, Whittington & Scholes, 2011). The latter perspective is

largely implicit in the former. Whatever the case, the strategic management process is the only framework through which the various functions required to set and meet the organization's objectives can be allocated between management on the one hand and governance on the other. This perspective introduces the normative assumption that governance seeks to achieve, or certainly influence, the achievement of an organization's goals and aspirations. The critical issue, however, is the appropriate allocation of Steps One to Five of the process between the board and management. A brief explanation on each of the stages of the strategic management process is now provided. The potential (including actual and observed) division of labour between the board and management is discussed at each step.

Figure 2. **THE FIVE STEP STRATEGIC MANAGEMENT PROCESS**



The discussion and the development of strategy can either be extraordinarily effective, constructive, engaging, motivational and compelling or, as is often the case, a shocking waste of time. The source of the dilemma appears to result from whether or not the purpose of the firm is seen as being distinct from its subsequent strategy. If the purpose of the firm is in any way ambiguous then the subsequent development of strategy is largely a fruitless exercise. Only when there is a common understanding of what is to be achieved, can strategy be effectively developed. The practice

of separating organizational purpose (what we are trying to achieve) from strategy (how we are going to achieve it) is necessary. Further, the discussion of purpose must produce a viable business model through which profit is achieved – or in the case of not-for-profit organizations ensure that some breakeven position is maintained while service provision and the expectations of stakeholders are met. Conventionally this direction statement is in the form of a vision or mission statement. Large organizations may even have both. In such circumstances the vision statement refers to a long-term objective while the mission statement refers to what needs to be done here and now - it provides urgency. The academic, research, and consulting communities have spent considerable effort and energy debating the merits, effectiveness, and occurrence of both vision and mission statements. Of more importance is whether or not a statement of purpose provides a clear sense of direction; where the company is heading; a real sense of discovery; the opportunity to explore the unfamiliar; and, a strong sense of destiny, achieving something really worthwhile. It ought to do all of the above and, arguably, is the sole responsibility of the board. An excellent example of simplicity of purpose is frequently reported by the highly successful Williams Formula One grand prix Team, where even the cleaner's role is understood as making the car go faster. At Air New Zealand under CEO Rob Fyfe's leadership a conviction and commitment to purpose across all parts of the organization became evident.

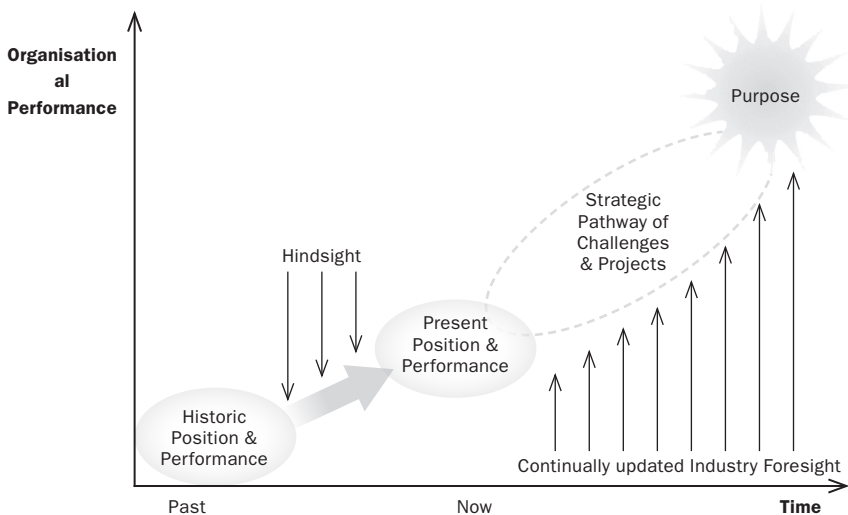
A second benefit to be gained by separating purpose from subsequent strategy concerns the consistency of effort. No one is disengaged faster, or disenfranchised sooner, than when they encounter inconsistency of thought, effort, and behaviour. There is a fair and reasonable expectation among all stakeholders (especially employees) that an organization will actually strive to achieve what they say they are trying to achieve. No organization can withstand non-alignment between purpose and strategy for long. This may explain why relatively few organizations have a well-developed and formally recorded sense of purpose that provides a constant reference point for strategy, values, behaviour, and the ethical stance that the organization adopts. The absence of formal process, or real commitment to a desired end-state provides considerable freedom to decision makers, supposedly management as a result of the agency problem. This deficiency should be the focus of the board's attention.

Only once the first question has been addressed, "what is it that we are really trying to achieve?" can strategy - how are we going to get there - be developed. Regrettably far too much effort is applied to the latter, often with

little more than assumptions being made about organizational purpose. First, determine organizational purpose which is the what then, and only then, develop the strategy required to achieve that purpose, the how.

The distinction between these two activities and how they relate to each other (their interdependency) is presented in Figure 3. The common assumption underpinning any discussion on strategy is the desire to improve performance over time, in for profit business this is referred to as competitive advantage - profit relative to competitors (hence the relationship between time (X axis) and performance (Y axis) being depicted as being positive over the long-term). Organizational purpose is something to be achieved in the future and it needs to be compelling. Governance and management then consistently align strategy to achieve that purpose. Therefore, organizational purpose serves to pull the organization into the future (Hamel & Prahalad, 1994). But to get to that future state from where the organization is today requires strategy: a strategic pathway of challenges and projects.

Figure 3. THE RELATIONSHIP BETWEEN ORGANIZATIONAL PURPOSE, STRATEGY AND PERFORMANCE OVER TIME



Therefore, the first priority of governance must be to determine the organization's strategic direction, who it intends to serve, the minimum level of performance to be achieved, and the ethical stance it adopts. The identification and setting of strategic direction must be undertaken by the

board on behalf of the owners (shareholders). Herein lies the first paradox of the division of labour - that of duality (Baliga, Moyer, & Rao, 1996). Where duality occurs one person has responsibility for the organization's management (CEO) at the same time as having the responsibility for chairing the board. Duality is a common phenomenon of founder-led/entrepreneurial organizations (Salancik & Pfeffer, 1980), arguably it is a critical characteristic of these types of organization. Pre Sarbanes-Oxley these same attributes were bestowed on the CEOs of the majority of American publicly listed companies in an attempt to better align their behaviour with that of entrepreneurs. The downside of this paradox is that all too often the CEO is regarded as the organization's critical decision maker (Khurana, 2002) at the expense of those responsible for governance. If it is the board's responsibility to hire and fire the CEO then the board must have considerable influence over the purpose of the organization beforehand and afterward. On what other basis can the CEO be recruited and engaged?

The Second Step of strategic management is environmental scanning (Thompson & Strickland, 2001). The external environment can be analysed through various techniques such as PESTE (PEST, PESTEL) analysis while the future environment can be determined more creatively through foresight (Hamel & Prahalad, 1994; Lockhart & Cartwright, 2001) and scenario learning (Schwartz, 1991). Similarly numerous tools and techniques are available to examine the organization's internal environment such as core competency analysis - operationalisation of Prahalad and Hamel's (1990) core competency theory. The processes of analysing the external and internal environments are, invariably, undertaken by management. In large organizations this is completed by employees in a strategic planning cell in close proximity to the CEO. Yet the process ought to be led by those assigned the responsibility for governance. For it is through the knowledge directors bring to the organization through their external ties (Carpenter & Westphal, 2001) that they can make a valuable contribution to environmental analysis and foresight development. Involving directors in only a passive role appears to mitigate the benefits to be had from their appointment to the board. Confusion is reflected in a range of studies that report, for example, on the various merits of independent directors (Baliga et al., 1996; Westphal, 1999) contrasted with their lack of power (Demb & Neubauer, 1992a, 1992b). Yet the board, and supposedly the organization's performance, may benefit from more collaborative executive-board relationships (Lockhart, 2006). In response to the lack of clarity of what

board members actually do researchers have sought to count the attributes of board members (see Dalton, Daily, Ellstrand, & Johnson, 1998; Ingley & Van der Walt, 2001). Yet recent black-box research in New Zealand (Crow, 2012; Edlin, 2007) supports the view that boards effectively contribute to the analysis of both the external and internal environments.

The respective activities are captured in *Figure 3*. Hindsight refers to the learning (Senge, 1992) that has gone on – what has been learnt on the way, how do the board and management actually think, and how does that influence the organization's view of the future? What biases are held as a result of past performance; and, what learning can be extracted from past mistakes? Therefore, hindsight is a process used to extract as much learning as possible from the organization's history and past performance and is as much the responsibility of the board as it is management's. The analysis of present position and performance requires that the organization confronts the brutal facts and to ask the hard questions – what is the business driver, what is its shelf life (is it already or when will it become obsolete), what are business relationships like, how good is the business and, how effective is its management and governance? Again this is a robust activity requiring analysis and effort by both parties. More importantly, it requires that both management and governance have the willingness to recognise failings and accept responsibility for past and current performance.

The last feature of *Figure 2* is continually updated industry foresight. The process of developing foresight – an organization's multiple views of the future – requires creative thinking for scenario building, and thorough analysis of those scenarios to ensure that they are plausible. Scenarios (views of the future) must be internally consistent, and an organization must have more than one. The future can almost always be captured by having multiple scenarios. Also at stake here is whether or not the organization has the courage to create its own future. A well developed, pre-determined organizational purpose, supported by a coherent and appropriately resourced strategy suggests the former (Hamel & Prahalad, 1994). This is the state to which good governance and effective management should aspire.

The Third Step of strategic management refers to the development of and eventual selection of strategy (e.g., Hill & Westbrook, 1997; Kaplan & Norton, 1996); stretch and leverage, fit and generic business strategies (Porter, 1980, 1985). The role of the board appears to diminish through the duration of this Step, until the point when a strategic decision is made. While the board must accept responsibility for the decision it is also

responsible for the creativity associated with the identification of choices. It is with respect to the strategy development function that the role of the board is, at best, obtuse. Wheelen and Hunger's (2002) classification of board activity, from 'phantom' to 'catalyst', has been observed to be useful in explaining the spectrum of engagement by boards with strategic management. Yet, various studies (e.g., Peebles, 2010) provide evidence that few boards actually control their own agenda - being largely passive observers of some distant process. Again black box research reveals the same range of involvement in strategy as Wheelen and Hunger from the catalyst (e.g., Lockhart & Taitoko, 2004) to the phantom board. Such studies are supported by anecdotal evidence across sectors, for example, the State Sector in New Zealand where board activity and influence with respect to strategy has been observed from being catalytic to phantom. This range of activity suggests the need for an effective normative response from boards, especially as both shareholders and stakeholders hold them responsible for business performance.

Strategic implementation, the fourth task, is the domain of management. That position is seldom violated except for extreme cases of management failure when boards have been observed to reach into organizations for a well-defined period. However, there remains the responsibility for boards to examine and approve management's implementation plans.

The fifth, and final task, is the measurement of strategic outcomes through various forms of evaluation and control. These outcomes (Mintzberg, 1989) will include profit; competitive advantage (profit relative to competitors), achievement of Triple Bottom Line performance measures and strategy itself - as observed by. Strategic control also provides the organization with a means of correcting errant and ineffective strategy while the control process provides a critical feedback to enhance organizational learning. Here again, the reports of board activity in both black box studies and larger scale quantitative analyses converge with each other. However, a preoccupation with the control function raises concerns over where the board's focus ought to lie: assiduous control is necessary but it will not, in itself, create value. Is the board's primary role to lead the organization into the future or to report on (and evaluate) where it has been?

The broader approach to strategic governance then recognises, but does not necessarily resolve the conflict between and among existing stakeholders, as implied in conventional definitions of governance (e.g., OECD, 2002). Those assigned the responsibility for governance, especially the board, must also address conflicts provided by the broader stakeholder group

and provide an appropriate means for their input into the organization’s decision making. A summary of the division of labour between governance and management, and other stakeholders, is presented in *Table 1*.

Table 1. THE STRATEGIC MANAGEMENT PROCESS AS A DIVISION OF LABOUR BETWEEN GOVERNANCE AND MANAGEMENT

Strategic Management Task	Role and Responsibilities		
	Governance	Management	Other Stakeholders
Determining the organisation’s direction	Set the organisation’s direction	Participate	Participate
Environmental scanning and internal analysis	Lead process	Conduct process	Influence
Strategy development and strategic choice	Identification of options and strategic choice, establish goals and performance criteria	Identification and analysis of options	Influence
Strategic implementation	Examine implementation plans	Lead and conduct	Lobby
Strategic evaluation and control	Set performance criteria, monitor and evaluate	Measure and report	Influence

Discussion

The strategic management process (or framework) through which corporate strategy is developed, implemented and subsequently controlled has been observed as a division of labour between boards and management (see Lockhart, 2012). However, no single model has yet emerged, or could rightfully be expected to emerge. At one extreme boards have been observed to ‘rubber stamp’ proposals from management while at the other they have been observed to be the catalyst (e.g., Lockhart & Taitoko, 2005) for the development of corporate strategy. Under such circumstances the CEO can be observed to take a ‘near project-management’ role.

The results from much black box research (Edlin, 2007; Martyn, 2008; Peebles, 2010) support the apparent, but variable, division of labour. More importantly at the catalyst end of the spectrum (see Figure 1) the board’s role is almost entirely focused on enhancing business performance - while not always achieving that outcome. For example, the Brierley Investments-dominated board of Air New Zealand conducted a high risk exit strategy from Ansett in the late 1990s that resulted in the collapse of the subsidiary and near failure of the parent. This strategy, opposed by management at the time, resulted in the near immediate resignations of the CEO and three

other members of the top management team once it had been implemented. That is not to suggest that boards are more inclined than management to get it wrong, but it is indicative of how involved boards can be in the strategic management process – as catalyst.

Where the responsibility for performance is held by the organization's governance, notably its board of directors, the division of labour concerning the strategic management process appears to be explicit. These boards take ownership of the strategy process. However, in doing so they will invariably credit management for success while accepting responsibility for poor performance themselves. There have been two notable public admissions to this effect by boards in New Zealand's primary sector recently: in the case of both Westland Milk Products and Silver Fern Farms boards have apologised to shareholder-suppliers for poor performance.

As importantly, the discussion of the division of labour presented in this Chapter overcomes Tricker's (1993) reflection that "organizations [were observed to have] peaked at the CEO" (p. 1). The vast majority of contributions to governance are grounded in a compliance focused, and/or agency prevention regime. But the role of governance in a process devoid of organizational performance, presumably a forward looking activity, is at best limited to reporting upon where the organization has been. Considering the roles and responsibilities of governance and management - what it is that boards actually do; how they do it; and, why - in terms of a division of labour, provides a means through which numerous grounded contributions can now be explored in a far more orderly manner.

Discussion Questions:

1. Discuss how the concept of a division of labour enhances the understanding of what boards actually do?
2. Explain how the concept of a division of labour contributes to your understanding of how boards add value to the organizations they serve?
3. Does the concept of a division of labour clarify which functions of strategic management the board needs to lead and which it effectively delegates to management? Why?
4. Explain how the roles and responsibilities of governance and management can now be interpreted and predicted in terms of a division of labour? Both now and in the future?
5. Discuss how the division of labour assists in understanding the wide range of research results that attribute, or fail to attribute performance to the board?

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BIOGRAPHY

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Chapter 14

**The Story of a Tortoise:
How Toyota Fell from the Top Spot³⁶***Shamsud D. Chowdhury & Jerry Paul Sheppard***Abstract**

In 2008, Toyota Motors achieved its goal of becoming the No. 1 carmaker on earth. Despite its ascension to the top spot, problems with electronic and physical systems of its cars morphed into a disease in early 2010. In three separate events, Toyota had to recall a total of 11 million vehicles. Toyota lost \$21 billion of its market capitalization in a single week in January 2010, and was slapped with an unprecedented penalty of three fines totalling \$48.8 million. For the first half of 2011, Toyota fell to third place, with GM and Volkswagen first and second, respectively.

This case explains how the failure of Toyota's corporate governance – especially its board structure – contributed to its fall from the No. 1 spot. Although the problem of sudden unintended acceleration syndrome was reported back in 1999, it took Toyota CEOs and its entire insider-dominated board more than 10 years to acknowledge its existence, let alone initiate any corrective measures. Despite swift governance reforms to include Anglo-American features of corporate boards in the mid-1990s in Japan, Toyota CEOs always dismissed the idea of appointing outside, independent directors. Although Toyota cut down the board size from 58 in 2003 to 29 in 2010, all the members were executives and insiders, and none independent. There were no dissenting voices that could raise the alarm that Toyota was going through a crisis, and that decisive and drastic measures were needed to control this crisis. The case calls to question whether all insider board members at Toyota performed their duty of oversight and discharged their statutory role in the execution of appropriate internal control.

³⁶ During the first author's sabbatical in the winter of 2010 at the ESSEC Business School in Paris, Toyota's accelerator pedal recall became a focus of mainstream media in France. Business journals made Toyota the lead topic. The author's interest was piqued and the result is this case. I am grateful to colleagues at the Department of Management, ESSEC Business School, especially Carole Donada, for their encouragement for the completion of this case.

Introduction

In 2008, Toyota Motors (Toyota) achieved its goal of becoming the No. 1 carmaker on earth.ⁱ Until then, General Motors (GM) had been the market leader in the global automobile industry for 77 consecutive years from 1931 through 2007. That same year, the financial crisis severely hit the auto industry. In the US, for example, automobile sales declined 18 percent, from 16.1 million units in 2007 to 13.2 million units in 2008.ⁱ

ⁱ The credit crisis, coupled with an already declining market share, customer perceptions about poor quality, redundant product offerings, and huge legacy costs pushed GM into bankruptcy court protection. In comparison, Toyota reported a \$4.8 billion loss during the first quarter of 2009, the largest quarterly loss in the company's 72-year history.^{i i} Although Toyota's setback was quite in line with its global competitors, what was to follow in the months to come was not at all in line with the company's previously exceptional record. Revelations of Toyota's quality control problems over the years were so disturbing that many found it difficult to reconcile this with the firm's historic stellar reputation for quality production methods. Such callous disregard of persistent quality problems on the part of the world's largest automaker was neatly summed up by the New York Times:

As Toyota returned to the black in late 2009, its reputation for safety and quality were battered by a series of recalls. The issue of unintended acceleration would lead the company through a bruising gantlet of government investigators, lawsuits from crash victims and one of the heaviest fines ever imposed on a car manufacturer in the United States.^{iv}

Resultantly, the number one sales position that Toyota achieved with a struggle stretching over 71 years was lost within two years to GM. Moreover, Toyota faced a risk for significant loss of brand equity and market share. This fall in Toyota's fortune was attributed to its obsession with growth; to its departure from age-old traditions and values; and, finally, to a broader failing of its board in the control and reversal of this battered situation. The following paragraphs chronicle the role of Toyota's board in its rise and fall during 1995-2010, a period marked by a record number of recalls and an unprecedented penalty of three fines totalling \$48.8 million.

Although a number of reasons, such as an overly ambitious growth goal for global market leadership, failure of crisis management, failure of internal communications, and failure to comply with US government regulations have been attributed to Toyota's problems leading to its fall,

the failure of Toyota's corporate governance has hardly been mentioned, either in the academic literature or in the business press, as a contributor to this crisis. Briefly, it is the examination of Toyota's governance failure, or more specifically the failure of its board, to which this case is dedicated. In order to bring this failure into perspective, a brief history of Toyota is presented first.

A Brief History

The history of Toyota can conveniently be divided into three uneven time periods: 1937-1956, 1957-1994, and 1995-2010. The first two periods represent its founding followed, with the exception of a few hiccups, by ever-increasing growth based on a "fastidiously tended" reputation for quality and reliability. In contrast to the first two periods, the last was plagued by a systemic and widespread scandal. A series of recalls involving faulty floor mats and balky gas pedals sullied Toyota's reputation for quality and customer loyalty, the long-term impact of which is still not fully known. The last stage spanned approximately 15 years.

The origins of Toyota Motors can be traced back to 1902 when Sakichi Toyoda invented a loom that stopped automatically if a thread snapped. This reduced defects and raised yields of usable fabric. His son, Kiichiro Toyoda, founded Toyota Motors in 1937. Kiichiro applied his father's system of designing processes to stop automatically and call attention to problems. Kiichiro also designed a system that provided different processes with only the kinds and quantities of items needed, when they were needed, which came to be known later as the famous "just-in-time" (JIT) inventory. Toyota also benefitted from the Second Sino-Japanese war in 1937, when the Japanese government authorized it, along with Nissan and Isuzu, to produce automobiles in order to break the dominance of large US automakers.^v Toyota's operations also grew significantly following the outbreak of World War II. However, because of the recession following the War, Toyota nearly went out of business in 1950. It survived the recession and made a comeback largely due to an increased demand for cars during the Korean War in 1950. Since this recovery, Toyota never lost money until the recession of 2008.

Toyota set up its first foreign headquarters in Hollywood in 1957 to sell its imported cars produced in Japan. However, its cars were selling dismally in the US due to design and manufacturing problems. This is when Toyota began to design and produce cars specifically for the US market. From 1965 onwards, Toyota's sales were nearly doubling each year. By 1971, Toyota

was selling over 300,000 vehicles per year.^{vi} After years of experimentation, Toyota perfected its production system by the 1970s.

The fabled Toyota Production System (TPS) – a standardized process to encourage and facilitate unique and creative employee contributions to its unified goals and objectives^{vii} – guided and supported Toyota's steady rise since its founding. The resultant tradition came to be known as the Toyota Way. The Toyota Way, which is more of a mind-set than a collection of management tools,^{viii} lowered costs, improved brand quality, and gave Toyota an enduring competitive advantage, and allowed it to grow faster than its rivals in the US and other markets.

Toyota made major inroads into the North American market when oil prices spiked in 1973 and again in 1979. The demand for better fuel efficiency and increased safety standards, as mandated by the US federal regulation, led to an unprecedented demand for smaller, lighter, and more efficient cars. Small car makers like Toyota were particularly well positioned to meet this new demand. In the 1980s, Toyota started to build manufacturing plants in the US. In 1984, the first Toyota Corolla was built in the US at the New United Motor Manufacturing (NUMMI) facility in Fremont, California – a joint venture with GM.^{ix} GM wanted to learn lean production from Toyota, and Toyota wanted to gain its first manufacturing base in the US, work directly with American workers, and invest in the local communities, hence the joint venture. Toyota achieved a revolution in NUMMI, in that it proved that lean production could be successfully replicated in manufacturing facilities in the US. In 1986, Toyota established its first wholly-owned subsidiary in Georgetown, Kentucky. This is Toyota's largest manufacturing facility outside Japan. Under the leadership of three non-family presidents – Hiroshi Okuda from 1995 to 1999, Fujio Cho from 1999 to 2005, and Katsuaki Watanabe from 2005 to 2009 – Toyota achieved a record of growth no other automaker had ever witnessed. In less than 70 years Toyota had become a \$100 billion corporation. This feat was topped by the fact that between 2001 and 2008 Toyota doubled its size – the most staggering growth for a car-maker the world had ever seen. And finally in 2008, with over 300,000 employees and 53 production facilities in 26 countries,^x Toyota replaced GM as the world's largest auto manufacturer. See *Table 1*.

**Table 1: ANNUAL PRODUCTION VOLUME OF VEHICLES
BY GM AND TOYOTA** ^{xliii}

Year	GM	Toyota
2001	7,582,561	6,054,968
2002	8,325,835	6,626,387
2003	8,185,997	6,240,526
2004**	8,066,536	6,814,554
2005	9,097,855	7,338,314
2006	8,965,305	8,036,010
2007	9,349,818	8,534,690
2008	8,282,803	9,237,780
2009	6,459,053	7,234,439
2010	8,476,192	8,557,351

** Toyota overtook Ford and became the No. 2 auto manufacturer in the world. It took Toyota only three years to beat GM and emerge as the No. 1 in 2008.

Corporate Governance in Toyota

Historically, a life-time employment contract, and a resultant employee-centered stakeholder model – as opposed to a stockholder-centered ‘Anglo-American’ model – approximated the governance of large corporations in Japan. ^{xi} Boards in Japan were composed almost entirely of inside members. Senior managers, who were career employees of the corporation, would achieve board membership as they moved up the corporate ladder. This composition created a foundation of trust in these managerial board members, which was based on a ‘lifetime’ involvement in and commitment to the company. ^{xii} In such boards, there was a low degree of separation between the management and monitoring functions. ^{xiii} Concomitant with Japan’s post-war growth, insider-dominated boards prospered until the mid-1990s. These insider directors however owed “fiduciary duties of care and loyalty to the corporation and shareholders” under Japanese law. ^{xiv}

Couched in this brief historical snapshot of corporate governance, Toyota’s key focus was always on its people, and its CEOs were committed to upholding job security of their employees. In 1998, Moody’s Investors Services downgraded the Toyota bond rating because of its commitment to lifetime employment, but Toyota had never budged. ^{xv} Senior managers, who were career employees of the corporation and moved up the corporate ladder, ultimately achieved board membership. This composition created

a foundation of trust in these managerial board members, which was based on a ‘lifetime’ involvement in and commitment to Toyota. Toyota was always touted as the most ardent champion of Japan’s traditional insider-dominated board. This stance went back to the early 1950s, when, following the end of World War II, Toyota was at the brink of bankruptcy and had to dismiss employees. Over more than half a century later, Toyota was never in deficit, and it did not have to lay-off employees for restructuring purposes.^{xvi} Even during the 1990s, Toyota doggedly defended its position against those who strongly suggested layoffs in favor of shareholder value.

As the influence of the main-bank system and cross-shareholding was waning following the globalization of financial markets, Japanese corporations began to undergo swift governance reforms in the 1990s. Since 1996, there were numerous amendments to Japanese corporate laws as part of an ongoing debate on corporate governance reform. “[A]n unprecedented shareholder derivative suit related to the \$1.1 billion trading loss scandal in Daiwa Bank’s New York branch in 1995” extended the directors duty of care “to establish and monitor an information and reporting system designed to prevent and detect wrong-doing by the corporation’s employees.”^{xvii} The legal precedent from the Daiwa Bank case made the debate poignant: whether the insider-dominated traditional Japanese boards were still effective in a changing global economy and if they needed to be replaced with the features of an Anglo-American board. A large number of corporations introduced significant changes in their boards. Sony, for example, introduced the executive officer system in 1997, and others followed suit. This system meant executives would be discharging operational responsibilities, whereas board members would be responsible for monitoring. Shaped by the mainstream argument in agency theory, this shift tilted toward an Anglo-American governance model, which is intended largely to facilitate the monitoring function of the board. Again in 2002, the newly amended Company Law adopted the committee system, which entailed the formation of three committees responsible for appointments, audits, and compensation.^{xviii} In 2005, in response to a new requirement for a minimum of three statutory auditors (of which a majority had to be from outside with no previous employment with the company), Toyota increased the number of auditors from three to seven, of which four were from outside of the organization.^{xix}

Despite this legal requirement, corporations could pursue alternative board structures to fulfill their duty of oversight. Until 2003, Toyota had

58 board members, or almost five times those of GM's.^{xx} This number came down to 30 in 2007^{xxi} and 29 in 2010,^{xxii} and all of the members were executives and insiders,^{xxiii} and none of them independent. Moreover, the directors – all men – lacked in diversity.^{xxiv} The directors held different titles, which indicated “fine gradations of a presumed hierarchical order of authority, responsibility and seniority.”^{xxv} Quoting Toyota's Form 6-K filed with the Securities and Exchange Commission, from June 29, 2007, presented the following rationale for having a board composed entirely of its own executives:

With respect to our system regarding directors, we believe that it is important to elect individuals that comprehend and engage in Toyota's strengths, including commitment to manufacturing, with an emphasis on frontline operations and problem solving based on the actual situation on the site (*genchi genbutsu*). Toyota will consider the appointment of outside directors should there be suitable individuals.^{xxvi}

Although the lack of an outside perspective was particularly striking in the case of Toyota's board, Toyota set up an International Advisory Board of ten experts as a surrogate for outside directors in 1996. The disciplinary role of this advisory board was questionable.^{xxvii} Toyota CEOs always dismissed the idea of appointing outsiders on the board, in that it was doing perfectly well without such outside members.^{xxviii} For Toyota, its insider board members could share knowledge and information acquired on the shop floor, thus facilitating incremental, “step-by-step” innovation. Over decades, Toyota built its reputation and market share in tiny increments, which could be best captured by the Japanese word *jojo*, meaning “slowly, gradually, and steadily.”^{xxix} Therefore, an insider-packed board was perfectly in keeping with Toyota's growth philosophy and attendant success.

The Biggest Recall in Automotive History

Despite Toyota's ascension to the top spot, problems with electronic and physical systems of its cars morphed into a disease in early 2010, and caused a hailstorm of recalls and bad publicity. At least 34 deaths were attributed to problems related to unintended acceleration and brake failure in Toyota and Lexus vehicles,^{xxx} and death tolls linked to these defects might reach 100 or more.^{xxxi} In three separate events, a total of 11 million Toyota and Lexus vehicles were recalled, by far the most extensive recall in automobile history. The timeline for all the recalls that spanned slightly more than three years is presented in *Table 2*. Toyota attracted intense

scrutiny, rebuke, and public outcry. Its failure to notify the US Department of Transportation (DOT) of the problems made its closely guarded values very questionable. The obvious outcomes were a sense of betrayal among loyal customers and fear and mistrust among potential buyers about the safety of Toyota vehicles. It would be difficult to predict exactly how the future would unfold for Toyota. The outcome of the pending class action lawsuits aside, Toyota lost \$21 billion of its market capitalization in a single week in January 2010.^{xxxi} It was slapped with an unprecedented penalty of three fines totalling \$48.8 million. For the first half of 2011, Toyota had fallen to the third place, with GM and Volkswagen first and second, respectively.^{xxxii} The timeline for the recall of Toyota vehicles is also given in *Table 2*.

Table 2: **TOYOTA RECALL TIMELINE: SOME KEY DATES** ^{xliv}

Date	Reason for Recall
September 2007	Toyota issued a Lexus recall to fasten floor mats to car floors to avoid acceleration problems.
August 28, 2009	Uncontrolled acceleration crash of a Lexus killed four people near San Diego, California, including an off-duty highway patrol officer.
September 14, 2009	Preliminary reports indicate that a Lexus, on loan from a Lexus dealership, may have had the wrong floor mats installed, interfering with the gas pedal.
September 29, 2009	Toyota issued a safety advisory on floor mats for approximately 4.2 million Lexus and Toyota vehicles, adding that it was recalling the floor mats.
October 02, 2009	Newly appointed Toyota CEO Akio Toyoda publicly apologized for the deaths in California, and to every customer affected by the recall.
October 25, 2009	An investigation by local authorities and the National Highway Traffic Safety Administration (NHTSA) revealed that a set of rubber floor mats designed for the Lexus RX 400 SUV had been placed over the top of the ES 350's stock carpeted floor mats and that the accelerator pedal had become jammed against them, causing the car to accelerate out of control.
October 30, 2009	Toyota began sending letters to owners notifying them of an unspecified upcoming recall to fix the unintended acceleration issue. In the letters Toyota claimed that "no defect exists."
November 16, 2009	Japanese media reports claimed Toyota had made a deal with NHTSA over a recall. Toyota denied any agreement had been reached, but the company admitted it had already set aside \$5.6 billion to deal with the issue.
November 25, 2009	Toyota dealers were instructed to remove the gas pedal and shorten it so it could not interfere with the floor mats.
December 26, 2009	A Toyota Avalon crashed into a lake in Texas after accelerating out of control. All four occupants died. Floor mats were found in the trunk of the car.
January 11, 2011	Toyota announced its brake override software fix will be made global by 2011.
January 21, 2010	Toyota recalled another 2.3 million Toyota-brand vehicles because of a problem with the gas pedal.
January 23, 2010	Agence France Press reported that Toyota might recall 2 million vehicles in Europe for the same problem.
January 26, 2010	Toyota announced it was immediately halting the sale of all models affected by the January 21 pedal recall, and that it will shut down assembly lines for those models at five North American plants for one week beginning February 1 to assess and coordinate activities.
February 1, 2010	Toyota announced a plan to fix sticky gas pedals and the part was shipped to dealers.
February 5, 2010	The Toyota president apologized at a news conference.
February 23, 2010	Congressional investigative hearings of Toyota began.
May 18, 2010	Toyota paid a \$16.4 million fine to settle regulatory charges that it was too slow to issue a recall for the acceleration problem.
July 2010	Toyota recalled 280,000 cars for engine problems.
December 2010	The Motor Vehicle Safety Act stalled on the House floor.

Since 1995 onward, following the change of leadership from the Toyoda family to outsiders, Toyota's orientation took a different turn. Hiroshi Okuda, appointed in 1995 as Toyota's first non-family president, pushed for excessive growth, which he continued with until he was removed

from the presidency in 1999. His two successors – Fujio Cho and Katsuaki Watanabe – followed in his footsteps. Overly obsessed with the lucrative US market, these three CEOs changed Toyota profoundly in terms of size and geographical dispersion of operations. As a result, Toyota developed a chronic pattern of reacting slowly to safety concerns, and was even failing to notify customers or the DOT of known defects in its previously sold vehicles. This failure also demonstrated a marked departure from its commitment to uncompromising quality and nearly perfect reliability of its vehicles.

Beginning with the 1990s, the pace of internationalization grew rapidly, as the Japanese government made foreign direct investment (FDI) a key priority to revitalize its sluggish economy. As a result, Toyota became increasingly internationalized with overseas production facilities and operations. In order to accomplish such explosive growth, cost cutting took on a new dimension, taking the TPS to extreme levels. Various programs aimed at drastic cost cutting resulted in savings of more than \$10 billion from global operating costs over the period 2000–2005.^{xxxiv} Under pressure, Toyota suppliers were also cutting corners in the design of parts. Toyota's existing infrastructure and resources could barely support this accelerated speed of growth, with the result that quality simply became unsustainable, and was clearly slipping. "The parable of Toyota is that the tortoise became the hare."^{xxxv} Toyota moved away from its famed Toyota Way, with which its senior executives in overseas operations had little or no experience. An MIT operations expert, Steven Spear, having trained in Toyota factories, said, "the Toyota Way – in which knowledge accumulated by élite cadres of engineers and assembly workers over many years is shared across the company – got diluted by the demands of production."^{xxxvi} Contrary to its vaunted commitment to lifetime employment, Toyota started to rapidly increase the number of temporary workers in 2004,^{xxxvii} and was replacing seniority-based pay with ability-based pay.^{xxxviii} Although an overzealous pursuit of growth had plunged Toyota into a disaster of immense proportions, there was no dissention in the board to voice that Toyota was going to through a crisis, and that decisive and drastic measures were needed to control the crisis.

Failure of Governance

Toyota's directors never paid serious attention to the events leading to the recall of 11 million vehicles and a hefty \$48.8 million penalty, although these outcomes were largely grounded in their own board structure. The

problem of sudden unintended acceleration syndrome was reported in some Lexus and Toyota models even back in 1999,^{xxxix} but it took Toyota CEOs – and by extension its board members – more than 10 years to acknowledge its existence, let alone initiate any definitive corrective measures. By all accounts, Toyota's board felt that these events were minor hiccups and would go away on their own.^{xi} However, the legal precedent from the Daiwa Bank case brought into question, once again, whether the directors of Toyota performed their duty of oversight and discharged their statutory role in the execution of appropriate internal control. As the chronology of Toyota's recalls would suggest (see *Table 2*), Toyota's board did not.

Both life-time employment and promotion from within led to acute inbreeding in Toyota. Managers were climbing the corporate ladder on the coattails of their seniors who were sitting – or would be sitting – on the board soon. This rigid system of hierarchy made it difficult to pass bad news up the hieratical ladder. This, in turn, made it difficult to respond to crises, such as recalls and harsh press publicity. Any attempt to short-circuit the hierarchy would be deemed as an act of disloyalty and a violation of Toyota's internal harmony and consensual corporate culture.^{xli} If Toyota's board had included outside members with diverse backgrounds and orientations, its response to the crisis could be different. Such outside directors might pursue effective information and reporting systems to exercise their oversight function more effectively,^{xlii} and Toyota would still be in the number one position in the latter half of 2011.

Discussion Questions

1. What distinctive attributes of Toyota's governance aided its success?
2. What distinctive attributes of Toyota's governance structure may have contributed to its quality problems?
3. What distinctive attributes of Toyota's management may have contributed to its quality problems?
4. What external factors may have contributed to Toyota's quality problems?
5. What are the differences between a stakeholder-centred board and a stockholder-centred board?
6. Why were stakeholder-centered boards in Japan incorporating features of the Anglo-American boards from the mid-1990s?
7. Discuss the pros and cons of insider-dominated and outsider-dominated boards.
8. Can an informal outside advisory board perform as effectively as formal outside directors? Why or why not?
9. Are outsider-dominated boards better-equipped to handle a crisis and why?
10. Did Toyota's board members perform their duty of oversight during its recall crisis?
11. Did Toyota's board members perform their statutory role in the execution of appropriate control during its recall crisis?

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3

Chapter 15
INTRODUCTION**Context and Character***Jens Mueller & Philippa Wells*

While governance structures and approaches might adhere to certain internationally accepted principles (OECD, 2004) Institutional Theory would imply the way in which they are applied or translated into practice must take the cultural framework into account (Erturk, Froud, Johal and Williams 2004). This is of importance not only to nationally based companies but to TNCs that look to expand into other jurisdictions (Kiel, Hendry and Nicholson, 2006; Yui and Makino, 2002). In addition, the nature of the organization itself has a role to play in determining effective governance.

Insofar as the broader cultural context is concerned, Li and Harrison (2008, 2008a) in their papers on corporate governance of multinational companies, argue that research into the subject has failed to consider the wide variation in governance structures across countries and by assuming consistency fail also to offer useful insights into how governance can be improved. The problems involved in drawing general conclusions on the quality of governance in different systems has also been raised by Aguilera and Jackson (2003); Cioffi (2000); Li (1994, 2007) and O'Sullivan (2003).

One obvious example of such variation is implicit in the two tiered board, common in Germany, to insider dominated boards in Japan to mixed ones in the United States, the UK and other members of the Commonwealth. To this range, outsider dominated boards could be added (increasingly the tendency in the United States as a consequence of the Sarbanes-Oxley Act 2002 and changes to the listing requirements of the various major exchanges (NYSE and NASDAQ (Alces, 2010))) and in the UK (after the Cadbury Report), Australia and New Zealand, as well as those dominated by lending institutions (Li and Harrison, 2008) or those with employees as mandated members (Aguilera and Jackson, 2003; Buher, Rasheed and Rosenstein, 1997).

In an attempt to address and clarify the comparative picture, Millar, Eldomiaty, Choi and Hilton (2005) classify governance systems according to a 'triad' (Miller et al., 2005, p. 163). They document the differing roles, behaviour and influence of players, including financiers, regulators and markets within these three categories and stress that these non-economic influences significantly affect the capabilities and behaviour of companies. Specifically, the three types they identify are the Anglo-American (the focus of much of the agency theory oriented corporate governance literature), the Communitarian (European dominated) and Emerging Market (covering much of Asia and Eastern Europe).

Shareholding patterns also differ. In some countries such as the UK and the United States they may be dispersed or diffuse (Coffee, 2005) or in some cases in the hands of large institutional shareholders (pension funds and the like). This pattern is different in other countries such as Japan (Coffee, 2005), France, Finland and Sweden with banks (Aguilera and Jackson, 2003; Buher et al., 1997), families and 'core investors' (Li and Harrison, 2008, p. 608) playing major roles.

Thirdly, different jurisdictions may not have the markets that are deemed requisite for agency theory to work well. Although active and significant markets for control, stock and management are highly developed and generally free in countries in the west, the same cannot be said for developing and transition economies where governments are moving from interventionist to regulatory regimes but are also wrestling with issues of flawed or absent market mechanisms and potentially anti-market histories and attitudes (Harriss et al., 1997; Kirkpatrick, Parker and Zhang, 2003; North, 1997).

By way of illustration of this argument, it is useful to discuss briefly Nwabueze and Mileski (2008) and their analysis of Swissair, a partly government-owned company "renowned as a flying bank and...national symbol" (Nwabueze and Mileski, 2008, p. 584). They point to findings that the Swiss business sector was effectively controlled by 300 people through a network of interlocking directorships (Steger and Krapf, 2002). Although there was a legally required separation of powers between the board and the management of this company, the board was populated by business colleagues and friends and political appointees. Business people on the board were also involved in other companies - whose board members were on Swissair's board - and Swissair was regarded as "source of national pride" (Nwabueze and Mileski, 2008, p. 584), an important consideration for the political appointees.

Given these realities, to challenge the decision of the CEO of Swissair to pursue a strategy of acquisition in the extremely volatile global aviation industry of the time (the 1990s) was to threaten the very structure of Swiss corporate governance. As a result, the Board failed to ask the right questions and the company ultimately failed in 2002.

Nwabueze and Mileski (2008) explain that agency theory would be inadequate in explaining how managers and directors in a situation like that prevailing at Swissair could deal with non-shareholder interests. Clearly here political considerations, social pride and social and business networks were much more important than either economic concerns or risk management (given the volatility of the aviation market of the time). Therefore, they opted for institutional theory given its ability to acknowledge that individuals within organizations may be driven by factors other than economic.

It is not only country-specific cultural context that is important in shaping and constructing governance mechanisms and practices. Over the last few decades the world has seen significant changes in how companies operate, where they do business and how they shape and implement strategy. Companies fight with governments, investors and consumers over tax liability, social responsibility and legal accountability (with just a few of the many high profile reported examples being Apple Inc over its tax liability (Business Insider, 2012), James Hardie Industries over its legal responsibility for compensating those contracting for work-related asbestos diseases (Wong and Switzer, 2012) and BP over the on-going implications from the environmental catastrophe in the Gulf of Mexico (Jamail, 2011)). However, there is also a growing awareness that in an interconnected world it is hard to hide: companies might look to shift activities to countries with weak governance mechanisms but it would appear that they are increasingly conscious of the broader ramifications of poor governance practices as customers, investors, the media and governments turn their jaundiced and sceptical eyes on their operations.

Hence attention is turning to alternative governance mechanisms and processes that might be applied by companies; alternative in that they do not fit the traditional (or Anglo-American) expectations or approaches. There is also some focus on issues of governance that arise where the context poses challenges to the implementation of effective governance systems. These are two themes explored in this Part.

Organization type also raises specific and sometimes vexing questions and issues for governance. As mentioned earlier, agency theory as a framework for a normative reward and control structure is not limited to the public, commercial corporation adhering to the traditional Anglo-American structure, but has underpinned professional, policy and popular discourse around governance in emerging markets, fundamental restructuring in the public sector, the and in some cases determining the shape of non-profit organizations in certain jurisdictions (Bale and Dale, 1998; Chhotray and Stoker, 2009; Mason, Kirkbride and Bryde, 2006; Millar and Abraham, 2006; Wallis, 1997). These trends are partly attributable to what Irvine (2007, p.1) terms “corporate creep”, as reflected in the growing use of professional consulting providers in the non-profit sector and the pressures on such organizations to adopt corporate systems (Irvine, 2007), in the push in the public sector for organizational mimicking of private sector expectations and on globalisation of industrial and commercial activity. Yet categorisation can be significant when it comes to governance as the social norms and expectations can be powerful disciplines on those involved or affected – in particular the underlying social culture of the organization (Millar and Abraham, 2006) can be quite different and important – religious/secular; national/international; charitable/non-charitable; human/non-human focused being just some of the possible dichotomies..

It has also been argued that governance processes that involve a too rigid adherence to the principles of agency theory also increases the costs associated with employment contracts for the CEO and other members of the top management team, as well as of inter-party contracts where other potential agency relationships exist, such as between directors, shareholders and internal and external stakeholders (of particular import for SMEs and family owned/operated companies). However, it does not necessarily provide equivalent benefits in the form of improved performance or growth. Good governance, Lockhart argues, ought to be grounded in such good outcomes. Therefore, rather than being “besotted with the explanatory power of agency theory” (Lockhart, 2007, p.69) SMEs should focus on governance mechanisms that can sustainably deliver high quality performance, good rates of growth, and balance the interests of stakeholders, employees, buyers, suppliers and the environment.

For example, it is arguable that “stakeholders” are of particular importance in the NPO context, justified as follows: NPOs by virtue of their definition do not have “owners” or anyone entitled to receive residual

profits (Jamali, Hallal & Abdallah, 2010; LückerathRovers, Quadackers & De Bos, 2009). Consequently, one of the pivotal foundations of the major alternative agency theory is absent (Millar and Abraham 2006). It is also arguable that the fundamental tenet – that an agent (or in the corporate context, the CEO or Manager) is self-serving – runs contrary to the traditional perception of the leader in a NPO as a person wanting to do good rather than do well, and that there are good reasons why a Board (if it has one) should wish to collaborate with a CEO or Manager rather than control (Hough, McGregor-Lowndes & Ryan, 2004).

In addition, lacking a paramount objective of profit maximisation, the strategy, objectives and behaviour of NPOs are multifaceted and fluid as they respond to social and political change in an attempt to remain relevant and functional. Where, for example, a Government assumes responsibility for public health, an NPO previously active in that area might turn its attention to providing support for the families of the sick, or where tenant participation in community housing schemes is actively encouraged by Government as a weapon against local authorities (McDermont, 2007), so those affecting or affected by the NPO and its objectives (Freeman, 1984) also changes.

Insofar as the public sector is concerned, a long-standing tradition in many countries for state ownership of commercial enterprises has varied among countries and industries and has typically comprised a mix of social, economic and strategic interests. Examples include industrial policy, regional development, the supply of public goods and the existence of so called “natural” monopolies. Over the last few decades however, globalisation of markets, technological changes and deregulation of previously monopolistic markets have called for readjustment and restructuring of the state-owned sector. (OECD, 2005, p.10)

Hence, and mainly since the 1980s, there has been a strong politically-driven push in many countries, developed and emerging, towards reforming the public sector within an agency framework and in some instances, full or partial privatization. The theme underlying this restructuring is that there should be no distinction between the forces driving public versus private sectors, i.e. that both structures should assume managers were “self-seeking individual agents operating with relentless opportunism in an environment fogged by uncertainty and private information” (Hazeldine and Quiggan, p.18) and that market forces would discipline those agents when pursuing that “relentless opportunism”.

The consequences of the process have been fundamental. In some instances, those considered either politically sensitive or judged as a public service remain under direct government management. However, the management of such activities is often still based on an efficiency model (including the expectation that government agencies compete against other providers for government funding and in some instances to generate at least part of their funding from the non-government sector). Others deemed “commercial” (providers of goods and services) have often been moved to a for-profit corporate format (sometimes known as “State-Owned Enterprises” or SOEs. Regulation and accountability mechanisms for SOEs are often deliberately designed to be “light-handed” with monitoring at “arms-length” from the Government that holds its shares so that the market forces can work more strongly and efficiently.

In recognition of the concerns around their governance, in 2005 the OECD issued a set of non-binding guidelines for the governance of SOEs (a term that in this instance embraces not only fully state-owned enterprises but those in which government has some interest). The principal foci of these guidelines include the separation of ownership and control (arms-length management), accountability and transparency of decision-making processes (including the pursuit of any non-commercial activities), independence of decisionmaking from political influence, business and other desired competencies as the driver for appointment of directors and management and clear authorisation of scope, activities and operations via legal provisions.

Critics argue that SOEs or their equivalent are neither subject to market discipline (because for political reasons are often seen as having an implied guarantee of survival and solvency) nor are very efficient providers of public goods (McKinlay, 1987). They also argue that government has no business being in business; nor is it easy to prevent the political masters meddling in the decisions of the SOE. At the other end of the spectrum, critics argue that the SOE model removes power and choice from the taxpayer (who might otherwise be in a position to influence government decision makers as to the direction and strategy of such organizations) and puts it instead into the hands of a few having no accountability to the “owners”.

Governance of such “non-corporate” organizations is the third theme addressed by chapters included here. It should be noted that some of the contributions effectively “cross-over” in that they explore the governance of specific organizations (other than the traditional privately owned

corporate) that operate in in the context of a non-traditional cultural context, while others, although clearly written from a particular cultural perspective focus on an organization or group of organizations only.

Chapters in this Part

Providing context for these studies and to spark debate and awareness around how companies make governance decisions, in **chapter 16** Taylor and Luong challenge the argument that corporations will locate to where governance expectations and demands are weakest. They explain instead that how societal pressures in many places, not just the physical location of the firm, for good corporate governance, increase the likelihood that firms will respond by engaging in self-regulation behaviour using certifiable management standards. They discuss such international pressures for good corporate governance and the strategic rationale that compels some firms to adopt them voluntarily.

Other contributions are more specific. The first group or set of such contributions could be loosely classified as public sector. Coincidentally, all these involve universities. In **chapter 17** Napal examines the governance issues that arose at the University of Mauritius, where the Vice Chancellor, despite having independence guaranteed by statute, found his ability to act to improve governance of the institution so restricted by political interference and direction that he felt compelled to resign. This case demonstrates clearly how even the best intended and designed governance systems can be corrupted and rendered ineffective by outside influences.

Similarly, Koku (in **chapter 18**) explores University governance but in the particular case of private universities in Ghana. He describes the background to the emergence of such universities and explains the governance issues that such institutions, their stakeholders and government seek to address. A particular matter that seems common and contentious is the balancing of commercial success and transparency of information on their social importance and achievements.

Finally, Shearer and Maes (**chapter 19**) report on the success for the University of South Alabama in collaborating with a privately-owned technology company to launch a regional academic research and technical park. They explain that the establishment of this park has proved positive for both the company and for the University but posed some unique governance challenges; challenges that had to be overcome with innovative approaches and structures.

Small to medium enterprises (SMEs) provide a focus for a second set of contributions. In their analysis of the challenges such enterprises face in the particular context of New Zealand, In **chapter 20**, Bather, Hewa-Wellalage and Reddy provide a useful framework in which to consider how and why governance should be considered important for SMEs and how those involved could implement useful processes and practices. In particular they emphasise that governance for SMEs does not have to be complicated yet is of immense practical value. They also identify sources of information and assistance on which owners of such enterprises might draw.

In **chapter 21** Tognazzo, Gianecchini and Gubitta explore a subset of (mostly) SMEs having shared and unique characteristics, these being family businesses and examine how well-designed and adaptable governance practices can support their growth and development. They offer recommendations as to how those involved in such enterprises should plan and organise their governance structures and processes so as to take full advantage of their strengths as family businesses but at the same time, prevent those same characteristics becoming a hindrance to prosperity.

Rennie (in **chapter 22**) chooses to focus on one of the principal governance-relevant concerns for SMEs: obtaining finance. As she explains, as capital is critical to the success of SMEs, managers and directors must make sure they understand the challenges associated with this process and take steps to ensure that they are able to effectively manage these challenges. The financing landscape for small and medium sized enterprises is significantly different than it is for large companies, in that SMEs often rely heavily on debt financing. Via her analysis of relevant research she provides a useful insight into how the governance of SMEs can impact on their ability to raise such finance.

Those in a third group explore different aspects of state enterprises and their governance. Chang (in **chapter 23**) highlights the prevalence of political interference in large government-linked companies in Malaysia that have distorted the concept of corporate governance. These cases illustrate how these Malay-controlled companies could circumvent legislation in the country and ignore the rights of minority shareholders. He concludes that the close relationship between businesses and politics results in a cosy arrangement that fosters corrupt practices to enrich certain politically-connected individuals and the top politicians.

Wells picks a similar theme with her discussion in **chapter 24** of Solid Energy New Zealand, a state owned Enterprise (SOE) that stands as

both exemplar and focus for identification and exploration of legal and governance issues around their nature, responsibility, answerability and institutionalisation. Questions included in this chapter serve to further highlight the dilemmas that must be addressed for such organizations and that ultimately may play a key role in their longterm sustainability.

In view of the significant contribution of the public sector and the dominant role it plays in the Indian economy, in **chapter 25** Oberoi argues cogently that improving governance in SOEs has assumed a sense of urgency. It is only reasonable, she says, that governments as owners must improve their expertise and improve the governance of their enterprises. However, she explains that corporate governance of state owned enterprises is a complex task. One paramount challenge is to find the right balance between the government's duty to be an active owner, while resisting undue political interference in the management of the company. Another challenge is to make sure that the government does not distort competition in the way it uses its regulatory and supervisory powers.

Third sector organizations (a term applied here to NGOs and NPOs) are the focus for a fourth set of contributions. The governance of NGOs is the subject of the contribution in **chapter 26** by Kahou Bi and Seny Kan, more specifically the governance-relevant characteristics, issues and successes of two quite different NGOs operating in the Ivory Coast (Côte d'Ivoire) in sub-Saharan Africa. The discussion is both thought provoking and informative in that it highlights the importance of such organizations in a country with weak public regulatory systems and emphasises that although their good governance is essential, it is often a function of chance rather than of strategy or rules.

In **chapter 27**, Velazquez also offers an interesting analysis of governance in the context of an NGO, this time in the United States. The NGO, Casa Guanajuato, runs to support and assist Mexican residents, many of whom are undocumented and/or from rural areas, in improving their immigration status, education and financial position. However, with its growth have come problems over its structure, relationships and answerability to various bodies. This has impacted on the founder and on others who disagree over its future direction. This case serves to highlight problems that can arise as any organization changes and develops.

Price-Sharps, Tillery, Poulsen, Guiliai, Vocovich-Cholakian, Roy-Pogutter, Newborg, Adam, Liao and Bermio-Gonzalez collaborate in **chapter 28** on an analysis of how the particular governance structures of a particular NPO (SERI) allows it to be particularly sensitive and

responsive to community needs, allowing SERI to excel at organizational emergence and responsiveness to community change. It also provides a cost effective means of providing excellent services to the community. The various contributors to this piece offer valuable insights via explanations of their respective roles and how they are supported and enabled through appropriate and flexible governance structures and practices.

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Chapter 16

International Self-Regulation as Good Corporate Governance: The Role of Certifiable Management System Standards

Glen Taylor & Sandy Luong

Abstract

In this chapter we examine how societal pressures for good corporate governance increase the likelihood that firms will respond by engaging in self-regulation behaviour using certifiable management standards in an international business context. We will examine international pressures for good corporate governance and discuss the strategic rationale that explains why some firms voluntarily adopt them to meet rising societal expectations for good corporate governance while other firms lag behind. We distinguish between more or less effective standards as well as the variety of goals served by standards, including the setting of new norms, spreading best-practice, pre-empting government regulation and trade-promotion.

Keywords: corporate governance, self-regulation, standards, regulation.

Introduction

The study of international business has as one of its central objectives the understanding of the strategies that motivate the decisions and actions of firms operating in global markets, and the private institutions they adopt to help them manage relationships with key stakeholders in multiple countries. By its very nature, international business requires firms to address issues of good corporate governance in a complex web of economic, social and political environments. In this chapter we examine some of the motivations firms have to adopt good corporate governance practices when engaged in international business. We use the example of international management system standards as an exemplary tool. Formalized management system standards provide an illustration of how firms align their environmental management policies on a global scale in response to the demands of customers and governments. These systems are needed by these firms to manage orderly global supply chains and to protect their own reputations for good governance.

The Governance Value of Certifiable Management Standards

A wide range of voluntary international standards are designed to guide the social and environmental conduct of firms in the global economy. Some of these standards are generic and could be applied to virtually any organization in any industry. Some standards are very specific to an industry. Some standards specify broad value statements that comprise normative codes of conduct with no requirements to adhere to a specific management system. Some standards focus on public reporting of information that is known to be highly valued by particular stakeholders, such as the investment community in the case of accounting information, or social policy advocacy organizations in the case of respect for human rights in the workplace or sustainable environmental management practices. Some standards refer to the adoption of very clearly specified management systems, sometimes referred to as management system standards.

The most rigorous standards are those that can be audited by third party organizations, which can then use their independent authority and expertise to vouch for the veracity of management claims about their use of that system. Classic accounting is a prime example that has grown to include all manner of social and environmental audits in recent years. These standards are not designed by governments, but rather they emerge from the interplay of societal actors representing both private and public interests. The responsibility for the administration of certifiable standards usually rests with representative organizations that are either formed by stakeholders for this purpose or already exist in some form as a representative of a special interest group. Standards can become so institutionalized in some jurisdictions that compliance with their content and requirements is prescribed by law, as in the case of accounting standards which in some countries are codified in civil law.

The leading sponsors of certifiable management system governance initiatives each have their own mission and goals influencing their motivation (Christmann & Taylor, 2009). The organizations which sponsor and design these standards are most often keenly aware of how their interests can be served by influencing the process by which these standards are designed. Firms with strong management capabilities in the area of social and environmental responsibility are more likely to be early and assertive adopters of rigorous standards. These firms are more open to collaboration with non-governmental advocacy organizations seeking to design standards that reflect the high end of industry best practice. In contrast, firms with weaker capabilities and/or less incentive to aspire to

high standards are more inclined to close ranks within a more narrowly defined industry reference group. These industry groups tend to design standards that are relatively easy to satisfy but serve the purpose of showing some willingness to adopt corporate governance standards so long as they are not too rigorous and do not require independent third party verification (Christmann & Taylor, 2009).

The Forest Stewardship Council (FSC) certification of sustainable forestry practices is an example of a rigorous certifiable standard that emerged from a broad coalition of stakeholders. By way of contrast, the Sustainable Forests Initiative (SFI) is an example of a weak standard sponsored by firms represented by an industry trade association. The FSC represents the coming together of a broad coalition of leading companies and NGOs for the purpose of setting a rigorous certifiable standard by which forest management practices could be judged to be either sustainable or unsustainable. In response to this high standard, the American Forest & Paper Association (AF & PA) acted as the convening sponsor of a competing industry controlled standard, setting relatively lax requirements that at the outset did not require third-party monitoring and auditing. Over time the rigor of the SFI standard had to be bolstered as NGOs effectively challenged its credibility. Governance of the SFI management standard was eventually transferred from the AF&PA industry association to an independent non-profit organization (now called the SFI organization) with broader representation on its Board that includes a mix of representation comprised of roughly one-third industry, one-third environmental / conservation organizations, and one-third professional and academic groups (Overdevest, 2004). The SFI standard is now the most widely adopted standard of its kind in the world, whereas FSC standard is the most stringent global standard for sustainable wood product certification. The global chemical industry experienced a similar shift from relatively lax industry controlled standards to more stringent third party certified standards with the Responsible Care Program (King & Lenox, 2000) that initially came under heavy fire from non-industry stakeholders.

Christmann and Taylor (2009) developed a typology of voluntary international standards based on an examination of variations among the goals of sponsoring organizations to explain how sponsor goals determine which initiatives are most likely to result in improved social conduct as well as drawing attention to the limits of effective voluntary initiatives as tools for firm corporate governance. Simply put, stringent voluntary standards rarely become widely adopted, and widely adopted standards are rarely

stringent. Management standards can serve a wide range of purposes such as setting broad norms for corporate governance as in the case of the Global Compact (Rasche & Waddock, 2013), or best-practice advocacy as in the case of the FSC, or the pre-emption of more stringent standards or government regulation as in the case of the SFI, or trade promotion as in the case of ISO 14000, which is now widely used as a selection criterion in global supply chains across a broad range of industries. The wide range of sponsors and their goals as well as the highly variable degree of stringency applied to validating the design effectiveness and third-party auditing of these standards is a reflection of both their promise and limitation as effective tools for good corporate governance. Later, we review the international context in which these standards are adopted.

Do Corporate Governance Guidelines Matter?

Does moving towards adherence to and implementation of various corporate governance guidelines have a noticeable and relevant impact on corporations? In this section we look at how a corporation may or may not be affected and why. We begin by examining what these guidelines typically look like. Some of the topics generally covered under corporate governance guidelines include the following: (1) overall objectives of the corporation; (2) roles and responsibilities of the board along with board composition including selection criteria, nomination process, independence, and leadership; (3) board committees; and (4) disclosure responsibilities (Picou & Rubach, 2006).

One study looked at the impact of good governance by examining the extent to which the announcement of corporate governance guidelines by a corporation is an indication of an increase in value for institutional investment (Picou & Rubach, 2006). Picou and Ruback (2006) analyzed this potential correlation by looking at the format in which the announcement was made. It was hypothesized that firms announcing governance measures would demonstrate a positive reaction in their stock price. Companies generally followed two formats in SEC filings: enactment of guidelines or enactment followed by the actual substance of the guidelines. The latter format allowed investors easy access to the provisions of the guidelines. Picou and Ruback (2006) hypothesized that firms choosing the second format should exhibit an immediate and positive reaction in stock prices as opposed to a delayed or no positive reaction when firms fail to provide the full substance of the guidelines (Picou & Rubach, 2006). The results of firms announcing enactment of corporate governance guidelines

that included the substance (the second option) saw an immediate and positive reaction in stock prices. Firms that disclosed adoption of corporate governance guidelines without also disclosing the substance of the guidelines showed a delayed reaction (Picou & Rubach, 2006). Picou and Rubach (2006) argue that this shows good governance has a positive effect on institutional investors.

Governments themselves can be directly affected by outside perceptions of their efforts to portray themselves as adherents to high standards for good governance practices. For example, governments that find themselves needing access to international aid have been known to try to shape external perceptions by making efforts towards good governance by passing reforms that are little more than window dressing to hide corrupt practices. Announcements of the adoption of international standards in the name of good governance should not be the only requirement for allocating financial aid to developing countries. While the principles of good governance systems can be described in general terms, failure to appreciate the context in which they are implemented can defeat the best designed system. For governance policy reforms to be successful the history and the culture of the country must be considered (Nanda, 2006). For example, Indonesia underwent a reversal of market confidence as the result of corruption and nepotism under the Suharto regime, which led to a financial crisis which required IMF intervention. Some of the reforms required by the IMF included new laws for bankruptcy, improved consumer and corporate governance, capital account liberalization, modification of subsidies, and independent audits of government departments and state-owned enterprises (Nanda, 2006; Government of Indonesia, 1998). However, the attempt failed. A lack of understanding of the country's history and culture left the IMF looking at systematic changes rather than solution of existing issues that needed to be resolved first, such as its debt burden (Nanda, 2006).

For similar reasons, disclosures of corporate good governance intentions should be viewed as insufficient in guaranteeing investor support and shareholder protection. Corporations can be equally adept at window dressing in an effort to gain investor interest by projecting a false perception having a strong corporate governance culture. However, when viewed as an indication of future governance intentions, announcements do have the benefit of providing investors with a tool by which they can judge a corporation's future actions (Picou & Rubach, 2006). When viewed critically (Erturk et al., 2004), one might be tempted to conclude that

all attempts to improve corporate governance inevitably result in some degree of disappointment. Existing procedural rules are insufficient and ineffective at controlling the “self-serving behaviour of social and political elites” (Erturk et al., 2004). Despite all the recent emphasis on good governance, it all too often seems that the existing rules are failing to produce the desired results, and in many ways the situation is seems to be getting worse. For example, huge increases in top management pay in many countries has produced growing social and economic disparities leading to the creation of a new elites whose interest may conflict the goals of good corporate governance. As a result, although the decade of the 1990s focused around shareholder value for the masses, what it produced was a greatly enriched group of management elites (Erturk et al., 2004).

By way of validation for Erturk et al.(2004) position: throughout the drive to formulate, introduce and cultivate principles of good corporate governance, a process that gained much attention in the 1990s the major goal was to ensure that boards are held accountable to their shareholders. By the 2000s, many started to associate the concept with disappointment as mechanisms for good governance failed to detect companies like Enron or World Com and their dishonest and fraudulent activities (Erturk et al., 2004). Using the U.S airline industry as an example, Erturk et al. (2004) show how past corporate governance efforts failed to curtail the poor actions taken by U.S. managers. As stock prices started to fall, many high level managers engaged in forms of insider trading while others abandoned ship with large payoffs, leaving the public morally outraged (Erturk et al., 2004). The media reported companies claiming bankruptcies while executives pocketed billions in earnings (31 July 2002, 2 September 2002).

International Pressures for Good Corporate Governance

The pressures for good governance are not the same for all firms in all countries (Ostrom, 1999). Some countries have very socially conscious customers and some introduce tough laws and regulations. Companies in other countries are subject to far less control. More specifically, in the more advanced industrial economies, societal pressures have gone a long way to force companies to meet expectations for voluntary social responsibility efforts combined with strict laws and regulations that impose constraints on corporate behaviour (Rondinelli, 2000).

Outside these variances, other forces are at work. The voluntary adoption of good corporate governance practices in countries with strong proactive regimes is not necessarily the result of a spontaneous desire on the part

of firms to be good corporate citizens so much as it is a rational response to the high potential cost of weak corporate governance. Firms know that damage to their corporate reputation can hurt their brand value and result in intrusive governmental actions that cost them more in the long run than exercising some self-restraint and taking responsibility to prevent harming the interests of the stakeholders that have the power to undermine their success. Thus, good corporate governance can be seen as an adaptive response to local pressures (Kassinis, 2006).

In contrast to the above, countries with weak local demand for social responsibility and weak governmental pressure for good corporate governance might be expected to provide few incentives for holding firms to high standards of conduct. Weak social and political environments might encourage firms to pursue lower standards of corporate governance. This assumes that firms only adhere to high standards of conduct to the extent they are forced to do so by local customers and governments. Firms operating in international markets are not merely subject to the vagaries of local stakeholders. On the contrary, firms in international markets need to adhere to standards of corporate conduct that are often independent of local conditions. In many cases, multinational firms are more of a driving force for high standards than exploiters of opportunities to lower their own (Christmann & Taylor, 2006).

At first glance, therefore, the opportunity for large corporations to exploit countries with weak economies seems clear. International legal institutions are notably under-developed and lacking enforcement capability, leaving national governments as the main vehicle for legislating global corporate behaviour. In a global context where trade and investment flows are fluid, firms can choose to relocate to countries with weak regulations. The risk of losing out to other countries has the potential to undermine the political will on the part of nation states to apply strict national laws and regulations (Leonard, 1988; Low & Yeats, 1992). Insofar as national regulations are prone to fail because international trade and investment undermines their effectiveness, we should not expect private firms to show a strong interest in imposing strict systems of self-regulation upon themselves if decisions concerning commitment to good corporate governance are primarily a function of the relative strength of local governments.

However, the relentless process of increased globalization does not necessarily result in lower standards of corporate governance and the consequent negative effects on the environment in developing countries. On the contrary, there are forces in the globalization process that reinforce

demand for good corporate governance. As the market becomes increasingly global, the conduct of global firms becomes more readily visible and the importance of disclosure as a way of developing good governance norms increases (Fasterling, 2012). Working conditions in factories can easily become the subject of news reports thousands of miles away from the factory. Mistreatment of employees, bribes and other forms of corruption, environmental accidents and negligent practices can be easily captured and broadcast to a global audience. Likewise, the irresponsible acts of suppliers fall increasingly at the doorstep of the multinational firm. The global supply comes under scrutiny just as if it was under the direct control of the multinational firm. Private management standard certification has been shown to be useful in addressing the impact of these kinds of operating in corrupt environments (Montiel & Christmann, 2012).

Multinational firms face added pressures that require them to manage their behaviour in one country as if it was being judged by stakeholders in all countries. Damage to the reputation of a global firm can be costly and time consuming to repair. In addition to the scrutiny they face in their own operations, global companies act as a channel pressures that transcend national boundaries, forcing global firms to monitor the corporate governance practices of firms in the global supply chain and holding them accountable for standards of conduct that surpass local legal requirements. This is true even when lax regulations and enforcement might otherwise tempt firms to exploit the weakness of countries offering themselves as pollution havens (Hoffman, 1999; Rugman & Verbeke, 1998). Rather than exploit weakness, the expansion of international ties among firms in this way has the potential to contribute to push firms towards higher standards. While globalization may provide opportunities for firms to take advantage of cross-country differences in laws and regulations (Christmann & Taylor, 2001; Spar & Yoffie, 2000), globalization also increases institutional pressures for adoption of private institutions in the form of self-regulation which reduce the temptation to exploit these opportunities. Even in countries with weak laws, global firms often face more critical scrutiny than other domestic firms (Kostova & Zaheer, 1999). This in part explains the paucity of evidence for industrial flight hypothesis that predicts private investment will flow to countries with the lowest government standards. Empirical studies find the flow of foreign direct investment has been far less negative than the industrial-flight hypothesis would suggest (Taylor & Christmann, 2001), and could in some ways can be very positive.

This brings us back to the question of standards. While certifiable standards are applicable in many circumstances, they are particularly important for good corporate governance in an international context. The political, economic, social and legal context in which business is conducted varies tremendously from one country to another. It is sometimes incorrectly assumed that firms will simply do whatever they can get away with in each local context in which they operate. In reality there are strong pressures on firms to apply high standards for good corporate governance wherever they do business. Part of this can be explained by the value firms place on the need to have a positive reputation for having high standards to instill trust and confidence in the eyes of the stakeholders on whom they rely. In an era of global communication, the reputation of a firm is more than merely a matter of local concern. If a firm is found to engage in unacceptable conduct it is unlikely to be able to defend itself in the court of public opinion by claiming that it only misbehaves in countries where it can get away with lowering its standard of conduct.

In addition to external pressures, many firms find it more effective to adopt high standards of conduct for themselves and then hold themselves to this high level even in places where they could get away with lower standards. Despite the dire predictions of economist who fear that multinational firms will scour the world in search of places to misbehave, there is at least some evidence that multinational firms bring along with them higher standards of good corporate governance that in turn puts pressure on local companies to improve their standards as well (Christmann & Taylor, 2001). For example, if corruption is rampant in a country where a multinational is doing business it might seem to make sense for the multinational to allow employees to engage in corruption as a way of adjusting to local business conditions. However, in practice, corruption comes at a high price for the multinational that will be judged not only locally, but by norms set in places where corruption is seen as highly offensive and inappropriate (Montiel, Husted, & Christmann, 2012). Even when the multinational firm might be able to lower its standards without fear of detection or sanctions, there is still a powerful argument against weakening its corporate governance standards. Low standards have a way of undermining firm performance in ways that can be not only costly, but in some cases can be a disaster for all concerned. Lower standards of conduct harm the effectiveness of the multinational firm in all aspects of its global operations.

It could be argued that governments might be tempted to try to attract international firms by offering lower standards, but they might be more

successful if they recognized that high standards for conduct among governments are also more attractive than lower standards. Indeed, government corruption creates a powerful incentive for firms making location and investment decisions. There is an economic reason why corruption is associated with countries at the lower end of the global socio-economic ladder. Low standards of conduct do not produce the fertile conditions for successful businesses to grow and thrive. Corruption comes at a high price to both the firm and to societies that condone it.

Implementing International Management System Standards

As explained above, the use of certifiable management system standards (Gilbert, Rasche, & Waddock, 2011) has grown increasingly widespread in response to global demands for good corporate governance. Firms voluntarily use management standards in an effort to overcome the risks associated with weak management controls in areas such as environmental management. Many of these management systems began as a way to systematically control quality within firms as well as their extended supply chains. Because they can be explained and implemented as general systems, they offer a relatively easy vehicle for firms to establish consistent and highly scalable management control systems. Over time, these systems have been adapted to include a wide array of management system for corporate governance such as environmental management and corporate social responsibility towards other stakeholders such as local communities and employees. Certifiable management system standards do not take the place of sound laws and necessary regulations, but they reflect the recognition that good corporate governance is no longer optional – it becomes a basic requirement for all multinational firms and the firms that supply them.

However, making formal statements about adhering to governance principles or adopting a specific management standard is not enough to ensure good corporate governance. Many firms find ways to become certified without serious intent to strengthen their capacity for self-governance. A substantial commitment to firm self-regulation is most often found when firms fear the consequences of being discovered for making a false commitment (Montiel, Husted, & Christmann, 2012; Fasterling, 2012). In addition, firms are not uniform in their use of these standards. They can strategically choose to adopt a weak standard if their capabilities are weak. Alternatively, they can choose a strong standard if their capabilities are strong. If a customer requires certification to a particular standard, the

firm still has some leeway in deciding how deep a commitment to make to fully implementing the prescribed management system. Most standards can to some extent be gamed, making it appear that the firm has more fully embraced the management system than is the case in reality (as can governance principles more generally). This can be accomplished by setting up parallel systems that have little operational substance but which give the appearance that the certified management system is in use. This is a complete waste of time and resources, failing to achieve the intent of the standard and committing something of a fraud. It is however far more common than most would prefer to admit. It is more commonly assumed that if a firm has been certified to a management system standard, then it must be fully committed to implementing the system in a meaningful way.

The degree of implementation of an international certifiable standard has been described as being 'substantive' if there is serious intent to make the system operational in the firm, or 'symbolic' if the firm merely wants to have the reputation benefit of being certified without following through on implementation (Christmann & Taylor, 2006). The probability of a firm strategically selecting substantive versus symbolic adoption of a standard is largely determined by external forces that led to the implementation. Firms in global markets face conflicting sets of external pressures (Kostova & Zaheer, 1999). The expressed demands of strategically important international customers have been found empirically to be an important driver of substantive adoption. When customers take the view that social and environmental responsibility rank highly in their supplier selection criteria, suppliers compete with one another by signaling their corporate governance capability as demonstrated by more substantively adopting international management standards. When customers show little interest in following up with their own efforts to discover the extent of adoption, supplier firms are more likely to back off their commitment to implementation beyond the symbolic effort necessary to gain the legitimacy of certification without committing to any substantive use of it. Firms in global supply chains are more likely to take this form of self-regulation seriously when their customers signal a strong interest in social and environmental performance and demonstrate their interest by doing their own due diligence audits (Christmann & Taylor, 2006) – in other words, trust but verify.

Conclusions

In many of less developed and rapidly developing countries it seems that the tools of government regulation are failing to protect society and the environment. Laws are either inadequate or not enforced. New forms of private sector self-regulation have emerged in part to meet the needs of firms seeking an effective and coherent approach to managing their own operations and their relationships with suppliers, employees, local governments and non-governmental organizations advocating for more effective corporate governance. Where governments lack the political will or capability to regulate private firms, the role of motivated and capable private sector actors becomes all the more important. Instead of exploiting the weakness of developing countries, multinational firms have surprising self-interested incentives to work at improving the social, economic and environmental conditions of developing countries as they search for viable new markets and good places to invest in global talent and production capacity expansion. Certifiable management system standards have come to play a large role in filling the gap between corporate governance in the private sphere and good governance in the public sphere. These standards are now so common that in some developing countries the adoption of standards such as ISO 14001 certification has often become a de-facto requirement for firms exporting to developed countries. Even in the absence of effective laws and regulatory enforcement, the governments of these same countries often promote the adoption of certifiable standards as a way to avert being caught in a “race to the bottom” implied by their ineffective laws and regulatory enforcement (King, Lennox & Terlaak, 2005).

Despite showing some promise however, it would be naïve to assume that good corporate governance obviates the need for good governance in a more traditional nation state context. For example, ISO 14000 can be an effective management standard but it does not specify the level of environmental performance that is needed to safeguard the environment. Even if a standard was universally adopted there would still be a critical role for government to play in setting the level of performance expectation. Governments can use management standards as a means to create incentive systems and sanctions that promote social, economic and environmental well-being that are consistent with the traditional performance objectives of investors (McWilliams, 2000). It is also obvious that social and environmental conditions in many parts of the world have sharply deteriorated in recent years. Pollution levels in parts of China for example speak of the enormous price associated with its rapid industrial growth and urbanization. Even

if they can be a force for good corporate governance, it will take far more than the actions of a handful of multinational firms and their suppliers to blunt the sharp spike in air and water pollution that has so badly poisoned the land, water and atmosphere.

In the final analysis, good governance is a matter not only for governments on the one hand or corporations on the other. It is a shared public-private responsibility that challenges us to see beyond the immediate costs we must bear to enjoy its benefits. There are solid economic reasons to commit to good governance in the short run, but an even stronger incentive comes from knowing that no man is an island, and the interdependence of life on earth cannot be ignored for long. Good governance represents a desire to create the institutions – both public and private – that will give us and the living things on which we all depend on a chance to thrive and not merely survive in some degraded form.

Discussion Questions:

Identify the key elements of good corporate governance.

Using a relevant case as an example, present an argument for why a corporation should engage in self-regulation.

What are corporate governance guidelines and how do they impact corporate and investor behaviour?

How do pressures for self-regulation vary internationally?

Specifically, how do pressures for self-regulation change based on local markets and laws?

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BIOGRAPHY

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BIOGRAPHY

Sandy Luong, M.A. has a background in political media and has worked at NBC News & MSNBC in Washington, D.C. covering national and international politics. After NBC, Sandy worked as an Editor of Politics and International Affairs for an independent news company in Berkeley, California. She has performed research in our nation's capital and overseas focusing on models of democratic stability and governance in regions of ethnic and national conflict. Sandy graduated with a BA from the University of California, San Diego and MA from San Francisco State University, both in Political Science.

Chapter 17

Political Interference in Academia

Geetanee Napal

Abstract

In Mauritius, as in many developing countries with an individualistic culture, many key posts are headed by people appointed politically. Having political nominees at the head of public bodies enables the political class to monitor the running of these institutions. The main national tertiary education setting—the University of Mauritius—is no exception.

The University of Mauritius is meant to operate autonomously. Members of the academic community have the duty to fulfil their responsibilities in a professional manner, under the leadership of a qualified Vice Chancellor. As is the case in all universities worldwide, the autonomy of an academic entity is a precondition to its long-term success, as independence helps sustain academic freedom. This chapter explores the events that led to the resignation of the Vice Chancellor of the University of Mauritius; the almost inevitable outcome of an increasingly fraught period of political interference and inappropriate pressures.

In 2010, a high-calibre professor was appointed to serve as Vice-Chancellor at the University of Mauritius, for a three-year period. Having worked in many countries around the world, the Vice Chancellor had great vision and ambitious reform plans for the institution. If allowed to function in an autonomous manner, the University would focus on providing quality education, while ensuring the employability of its graduates. However, the institution needs to be properly equipped if it is to provide a better service. The current trend is that a high percentage of young graduates encounter major difficulty to secure a job, for varying reasons. Student profiles may not match employer expectations, or they may have difficulty accepting work conditions and salary proposed to them. How does one change such attitude in an emerging nation amidst crisis conditions? Although there is no easy answer to such problem, one reality is that political interference, as described in this paper, is not a solution.

Over the last two years, the institution experienced instances of political interference that eventually led to the resignation of the Vice Chancellor. This case illustrates how political interference can be detrimental to the smooth functioning of the system, thereby impacting on leadership style, governance and service.

The Relevant Legislation

Mauritius is an emerging economy where there has been slow progress in the field of ethics over the last two decades. While ethical issues like corruption or money laundering used to be viewed as a taboo subject, there are now open discussions of the dangers associated with a corrupt setting and poor governance.

The University of Mauritius was founded under the University of Mauritius Act of 1971. The legislation makes provision for the various authorities that are expected to govern the operations of the institution. There is no explicit provision for political intervention, which leads to the assumption that the University of Mauritius, like most tertiary academic entities worldwide, should be allowed to operate as an autonomous body and derive the benefits of academic freedom.

A Vice Chancellor is appointed to head the institution, on the terms and conditions as recommended by the Statutes (Section 20 of the University of Mauritius Act 1971). Once appointed, the Vice Chancellor is viewed as the chief executive officer of the establishment. A Vice Chancellor is responsible for academic and administrative matters and is expected to maintain and promote good governance. He is accountable to the Council of the University and his terms of employment are laid down by the Statutes, that is, bylaws devised by the Council after consultation with the Senate, by special resolution. The Council may require the Statutes to regulate any matter arising, for example, any specific duties or terms of office of the Vice Chancellor.

Below are the relevant extracts of the legislation:

Section 11 of the University of Mauritius Act 1971 stipulates that:

- (1) There shall be a Vice-Chancellor of the University who shall be the principal academic and administrative officer of the University, and who shall have general responsibility to the Council for maintaining and promoting the good order and efficiency of the University.
- (2) The Vice-Chancellor shall be appointed and shall hold office on such terms and conditions as are prescribed by the Statutes.

According to Section 15 of the University of Mauritius Act 1971:

- (1) There shall be a Council of the University which shall be the executive body of the University and shall have the custody, control and use of the common seal of the University.
- (2) The Council shall be responsible for the management and administration of the revenue and property of the University, and shall have general control over the conduct of the affairs of the University.
- (3) The constitution and terms of membership of the Council shall be as prescribed by the Statutes.

Section 16 of the Act makes provision for the setting up of Senate:

- (1) There shall be a Senate of the University which shall be the academic authority of the University and shall subject to the powers and functions of the Council as prescribed by the University of Mauritius Act 1971 Act and the Statutes, be responsible for the academic work of the University both in teaching and in research, the award of degrees, other than honorary degrees, diplomas and other academic distinctions and the regulation and superintendence of the education and discipline of students.
- (2) The constitutions and terms of membership of the Senate and its powers and functions shall be as prescribed by the Statutes.

In addition to the above, the provisions of the Statutes (Section 20, University of Mauritius Act 1971) are such that:

- (1) The Council may, after consultation with the Senate, by special resolution make Statutes for:
 - (a) Any matter which is required by the Act to be prescribed by the Statutes;
 - (b) The powers and functions, constitution and terms of membership of such bodies as the Council or the Senate may think proper to set up and to be so prescribed or regulated;
 - (c) The functions, duties and terms of office of such officers as the Council may think proper to appoint and to be so prescribed and regulated;
 - (d) All procedural or other matters such as the Council may think proper to prescribe or regulate by Statutes in furtherance of the objects of the University.
- (2) The Statutes set out in the Schedule to this Act shall be deemed to have been made under this section.

- (3) For the purposes of subsection (1) “special resolution” means a resolution passed by a majority of not less than two-thirds of the members of the Council present and voting at a meeting of the Council attended by not less than half the total membership of the Council, and notice of which shall, subject to the provisions of the Statutes, have been given to each member of the Council not less than fourteen days before the meeting is held.

From the above provisions, it can be inferred that the Vice Chancellor is free to exercise his good judgment to govern, as long as he acts in good faith and in the interest of the establishment. There is no explicit provision for the monitoring of the Vice Chancellor other than the general provisions under Sections 15 (2) and 20 (1b). Under Section 15 (2), Council is to exercise general control over the conduct of the affairs of the University. Section 20 (1b), on the other hand, provides for the regulation of the functions, duties and terms of office of specific officers, as viewed necessary by the Council. Regulation would be in order in case of misconduct on the part of the office holder, which does not at all apply to the case under discussion. However, it is worth noting that the members of Council are political nominees. It is therefore understood that the latter are accountable to the political people who appoint them.

Corporate Governance and Corporate Social Responsibility

As a conceptual framework, agency theory best reflects the relationship between the Vice Chancellor and Council. Agency theory views the governance relationship as a contract between the shareholder (principal) and the chief executive officer (agent). Council members are appointed by Government and therefore can be considered agents of the government and indirectly the taxpayer. At the end of the day, members of the Council are therefore responsible to the government. In principle, the CEO—in our case, the Vice Chancellor—is more knowledgeable than the shareholder/s, implying that the latter should logically empower and trust the former to fulfil his responsibilities.

As highlighted by Jensen and Meckling (1976), “agency theory involves a contract under which one or more persons (the shareholders) engage another person (the directors) to perform some service on their behalf which includes delegating some decision making authority to the agent (cited in Tricker, 2009, p. 219). Good corporate governance encourages good corporate performance, which makes trust a determining factor in stakeholder relationships. Securing successful stakeholder relationships

is as important as sustaining the long-term goodwill of an establishment (Hagan and Moon, 2006), hence the relevance of concepts like corporate social responsibility (CSR) and corporate sustainability (CS).

Stakeholder theory could be viewed as a suitable framework for a publicly owned educational body. Under this theory, decision makers take into account stakeholder concerns when involved in strategy formulation and decision making. Corporate social responsibility principles would encourage the university to address stakeholder concerns and adopt responsible business practices to sustain long-term development (Bannerjee, 2008; Bowie and Schneider, 2011; Metcalf and Benn, 2012; Morhardt, 2010). Referring to Carroll's CSR pyramid, the primary responsibility of an organization is to pursue its economic duty which is profit maximization. Along with this economic responsibility however, an organization has the legal obligation to obey the law, the ethical responsibility to do what is right and avoid doing wrong and the philanthropic responsibility to demonstrate good corporate behaviour (Krishna et al., 2011; Hind et al, 2009; Montiel, 2008). Corporate social responsibility is a values-based alignment of maximizing returns with a synchronized concern for people and the environment for future generations (Jones and Millar, 2011; Montiel, 2008, Wong, 2009).

Is the above not as applicable to the service sector where the organizational mission is to offer quality education to a target population willing to invest in their development? Should policy makers—in our case, the Council— not pursue their duty, which is to lead and govern in a socially responsible manner?

What follows is an overview of the incidents that led to the resignation of the Vice Chancellor.

Political Interference amidst good governance

In January 2010, a Vice Chancellor of British origin was recruited on a contractual basis, for a period of three years. Before joining the University of Mauritius, this academician worked in North America, in Europe–Scandinavia, the United Kingdom and Mid-Eastern countries. He was well-acquainted with different education models that are operated worldwide, and was therefore the appropriate person to devise a reform proposal for the institution. He consulted all the staff and came up with a very good plan of action for the University of Mauritius². The Vice Chancellor followed a democratic approach, as he believed in an open and transparent system of communication. His main objective was to promote the ideals of world-class education and maintain quality standards of performance. He was of

the view that an open and democratic management style could positively transform the system.

The Vice Chancellor was committed to the progress of the institution and used his special knowledge and skills to assist in the development of the academic community, guided by proper ethics. Leading by example, he handled the pressure associated with the daily issues common to a tertiary education institution in an era of crisis, with loyalty, wisdom and moderation. He empowered and trusted his people, showing confidence that desired results would be achieved. Throughout his short tenure, the Vice Chancellor made positive changes to the working environment. There was substantial capital investment for new equipment and considerable improvement in terms of health and safety on campus over the last two years. Focusing on teamwork, he encouraged research in a supportive manner and invested in staff development to give equal chances of funding to everyone, encouraging all staff to fulfill their aspirations.

However, the Vice Chancellor encountered problems common to the developing world, as norms of ethics in Mauritius are not remotely similar to those prevailing in the developed world. In May 2010, a ministry for tertiary education was established and a minister appointed. Throughout his term of office, the Vice Chancellor faced pressing demands from the ministry on a constant basis. He was expected to submit a report to the minister every fortnight. Amongst other things, he got instructions, through the Tertiary Education Commission, to investigate the results of students who were unhappy about their examination performance³. The minister convened weekly meetings with Heads of Department, an initiative qualified as unacceptable interference in the independence of the University of Mauritius. The press reported that political interference was hindering the progress of the institution⁴. It was feared that this approach could remove the University of Mauritius authorities from the operational management of the establishment⁵. In other words, the authorities, as established by law, would have no input in the management of the institution. Office holders, including the Vice Chancellor would not be empowered to fulfill their responsibilities. Instead, key decisions would be dictated by the political class.

Overall, the Vice Chancellor developed a good reform program for the university, but he faced considerable difficulty when it came to the implementation phase. There were strong objections on the grounds that some re-distribution of power would take place, as a result of the restructuring. After dedicating two years of his career to the University

of Mauritius, the Vice Chancellor resigned as a result of a combination of factors.

Main Issue and Potential Solution

Political interference causes good leaders to lose faith in the system. People lose confidence, which impacts adversely on their productivity. Over the last few years, there has been an overwhelming feeling of frustration and skepticism amidst the Mauritian population. While political people believe that they provide a positive benefit to the community⁶, the student population openly express their discontent on the inefficiency of the authorities at addressing their concerns⁷.

The education sector should be considered as a priority item on the agenda of the government. Tertiary educational institutions should be allowed to function autonomously, if the academic community is to perform optimally and provide a satisfactory level of service. In the absence of proper leadership and where the corruption of power predominates, a university faces high risks of operating at a sub-standard level, impacting on the quality of education being provided. The people, in particular the student population, are likely to be the most prominent victims of power abuse. Such strategies are dangerous under normal economic conditions, but are bound to be far more disastrous in a global financial crisis situation.

In spite of all the difficulties he encountered throughout his two years spent at the University of Mauritius, the Vice Chancellor still holds that a participative approach is the key to success in academia. His views do not only match what HR pioneers and contemporary ethicists advocate, but present further evidence of his good faith and respect for the people. Had the Vice Chancellor's reform strategy been implemented, it would have been up to the authorities to allow the institution sufficient autonomy to regulate itself through peer review. It is an established fact that universities that operate independently get to enjoy the benefits of academic freedom. High aspirations in terms of professional ideals coupled with effective peer review mechanisms to maintain acceptable standards of competence and ethical conduct could have contributed to the smooth running of the university. However, for the system to work effectively, the support of both academic and non-academic staff is needed. The university should have good governance practices and operate in transparency.

Referring to public service regulation mechanisms, good governance implies:

1. Focusing on the organization's purpose and outcomes for citizens and service users
2. Performing effectively in clearly defined functions and roles
3. Promoting values for the whole organization and demonstrating the values of good governance through behaviour
4. Taking informed, transparent decisions and managing risk
5. Developing the capacity and capability of the governing body to be effective
6. Engaging stakeholders and making accountability real.

These are the six primary components that figure in the “Good Governance Standard for Public Services” document, published by the UK Commission for Good Governance in Public Services, in 2005).

From an objective standpoint, the Vice Chancellor was well-versed in the principles of good governance. Through his democratic management style and good faith, he respected all the above criteria.

Considering the above-mentioned issues, the following are options to consider, in search of a long-term solution:

1. The political class should be convinced that interference does nothing but drive away trust, compromise goodwill and adversely impact on key institutions and on the people.
2. In a small-island economy, civil society and pressure groups should insist on a democratic approach to reform. A democratic management style helps promote trust and sustain satisfactory levels of motivation, provided there is no abuse.

Conclusion

Referring to principles of good governance, as discussed above, it is understood that the agent (a highly qualified expatriate) deserves the trust of the principal (the Council of the University of Mauritius), if he is to contribute to the objectives of the institution in a constructive manner. The agent is exposed to the daily issues associated with the management of the University and is therefore best placed to formulate key decisions and find solutions to problems, in the interest of the institution and its people. Trust is the key element that helps consolidate the governance relationship, enabling the agent to manage autonomously and soundly, to the satisfaction of the principal. Political interference impacts adversely on the principal/agent relationship, whilst sending the wrong signal to the main stakeholders that is, the staff and students of the University.

The University of Mauritius gets most of its funding from the Ministry of Finance and the Tertiary Education Commission. A feeling of distrust comes with political interference which in turn gives rise to concern over the governance of publicly funded bodies such as universities. Already, the University of Mauritius encounters difficulty to secure funding, and is faced with strict control mechanisms. The Vice Chancellor managed to decentralize the system for greater efficiency, but could the authorities to which the University is accountable have a problem with a flexible approach? If such is the case, control systems could be reinforced, giving way to more rigorous bureaucratic procedures, irrespective of whether or not such measures are justified. One unfortunate reality is that similar strategies operated successfully in other tertiary education institutions worldwide, but failed in the Mauritian context. We owe this both to our bureaucratic nature and to our political system.

The problems discussed above tend to impact on the quality of education being dispensed. The resignation of the Vice Chancellor is a loss to the institution and gives rise to a number of ethical issues:

1. In a so-called democratic system, is it legitimate for a minister to intervene in favor of students who are performing poorly in a tertiary institution headed by an expatriate with high credentials?
2. Is political intervention a mechanism employed to eventually remove the University of Mauritius authorities from the operational management of the institution?
3. Should the Tertiary Education Commission exert pressure on a university to review the results of students who failed examinations?
4. Is it reasonable to let go of real progress and use power for purely control purposes?
5. Is the exercise of political power more important than evolution in a national tertiary education institution?
6. Does sacrificing a world-class expatriate's academic profile present a justified way-out?
7. What message does the political class send to the public when they intervene in a tertiary academic institution that is expected to operate autonomously, the end outcome being the resignation of a highly qualified Vice Chancellor?
8. What is the likely outcome of mismanagement at a time the financial crisis is hitting hard, in a key sector where the appropriate expertise is not available locally?

9. In conditions of a global economic crisis, should we not value ethical leadership, put trust relationships first and aim at changing mindsets, rather than give priority to politics?
10. What message would political interference convey to a world-class academician who took the initiative of implementing a system of sound governance, in an emerging nation that had everything to gain from his democratic management style?

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BIOGRAPHY

Geetanee Napal worked as an HR practitioner in the business sector before joining the University of Mauritius. Her doctoral thesis is entitled: “Modelling Business Ethics in the Developing World”. Her publications include books entitled ‘Disclosing Corruption: a move towards transparency in Mauritius’ (2001); ‘Organization Development: a human resource strategy approach to change management’ (2002), papers on ethics/corruption in journals including Business Ethics: a European Review; Electronic Journal of Business Ethics and Organization Studies; International Journal of Knowledge, Culture and Change Management; The Journal of the South East Asia Research Centre for Communication and Humanities, and book chapters in “Business Ethics: Decision-Making for Personal Integrity and Social Responsibility”, McGraw-Hill, 2011. She was the lead researcher and sole author of the Transparency International National Integrity Systems, Country Study Report for Mauritius, 2004.

Chapter 18

Corporate Governance: The Case of Private Universities in Ghana

Paul Sergius Koku

Abstract

Private ownership of universities is a new phenomenon in many developing countries especially in Africa where the universities, until recently, were run by the government. This chapter examines the corporate governance issues related to private ownership of universities in Ghana. The chapter first reviews the sparse but emerging literature on corporate governance in Africa and discusses the legal context within which corporate governance is viewed; then it focuses on Ghana and traces the evolution of its current legal and education systems. Next, it discusses the value of earning a university degree in Ghana (it often serves as a way out of poverty not only to the holder of the degree, but often to his/her extended family). With this background, the chapter discusses why the government allowed private ownership of universities and the mechanisms through which it tries to maintain a national academic standard. The chapter notes that some of the private universities are operated for-profit and established by entrepreneurs while others are not for-profit and established by churches or affiliated with a religious entity. Some structural distinctions between private for-profit and private church-based or affiliated universities and their associated corporate governance issues are discussed.

Introduction

This study examines corporate governance issues associated with private universities in Ghana. This topic is of interest for two main reasons. Firstly, the concept of a private university is relatively new in Ghana, where university education has traditionally been provided by the government alone and until recently for free. Hence, there is a great deal of interest in the organizational structure as well as the accountability of leadership of this new phenomenon – private universities. Secondly, even though not all private universities in Ghana are for-profit the desire to make all these

universities to be self-sustaining financially, creates a healthy curiosity about the mechanisms in place that prevent them from increasing their profits by admitting students who have otherwise not met the minimum university admission requirements in the country. This interest is well-placed given (a) the inability of the marketplace to play a proper quality monitoring and quality discriminating function as far hiring university graduates is concerned, and (b) recent scandals surrounding the admission of some students by some private universities who did not meet the minimum university admission standards in Ghana (Kokutse, 2011; Modern Ghana, 2012).

The concept of corporate governance is discussed elsewhere in this publication. However, and for the purposes of context, both the concept and its theoretical framework are briefly reviewed below. In 1932, Berle and Means' discussed the concept as well as the problems associated with the separation of owner-manager (Okpara and Kabongo, 2010). However, the term "corporate governance" is relatively new. It became popular during the current decade, and now used liberally in corporate boardrooms, the business press, and in academic conferences and literature.

The popularity of the concept followed in the wake of the massive corporate frauds involving such world-class companies as Enron, Arthur Andersen, Worldcom, and Quest Communication. The large-scale financial deceptions that were perpetrated by these companies triggered citizens' reactions that culminated into legislative hearings on both sides of the Atlantic. These hearings formed the basis of regulations that have strengthened the fiduciary obligations of corporate executives, their boards of directors, and financial auditors. In United States, the hearings culminated in the now famous Sarbanes-Oxley Act, while in the United Kingdom it led to the highly cited Cadbury Report (Cadbury, 2000; Public Law 107-204, 2002).

Despite all the attention, the concept of corporate governance is difficult to articulate. This difficulty is evident in the different definitions of the concept that are available. Corporate governance could be viewed at a narrow level as that which "deals with the ways in which suppliers of finance to corporations assure themselves of getting a return their investment" (Shleifer and Vishny, 1997 in Okpara and Kabongo, 2010). Because shareholders who generally supply the finance to corporations are separated from these corporation and management, this narrower definition leads to the "management – shareholder" model that is used by many scholars to analyze corporate governance issues.

According to John and Senbet (1998) there is a broader view that sees corporate governance as that which “deals with mechanisms by which stakeholders exercise control over corporate insiders and management such that their interests are protected”. Indeed, corporate governance could also be viewed amongst other things to include a system of checks and balances, regulations and accountability to ensure that the goals for which an organization has been established are being met effectively and efficiently (Rossouw, 2009). This view and others like it reflect the belief that corporations are accountable to entities that are beyond their shareholders, or just those who provide their finances. These entities include the communities in which the corporation exists, the suppliers with whom the corporation deals, the employees who work for the corporation, management, owners of the company, and the government; they are collectively referred to as the stakeholders (Freeman and Reed, 1983). This view has led to what is known as the “management – stakeholders” model.

The principle of accountability of agents to their principals forms the backbone of the Anglo-American concept of corporate governance. This concept is well established in the British common law which is practiced in its former colonies including Ghana. However, for reasons that will become clear from the following discussion, this model is not necessarily suitable.

Ghana and Corporate Governance-Background and Context

As a former British colony, Ghana has an “inherited legal system” that is not only alien to Ghana’s traditional culture, but which on occasions also clashes with its traditional practices. Such is the case of corporate governance which demands accountability from decision makers (managers). Decision making by tradition in African countries and in Ghana is communitarian in nature (see Gyekye, 2003; Wiredu, 2003), thus, chiefs and elders make decisions in consultation with others, most likely members of the chief’s council.

However, because the colonial governors and their administrators were not accountable to the traditional leaders, but only to the British Imperial Government, the natives of the colonies perceived the representatives of the British government in Ghana (then known as the Gold Coast) to be accountable to no one. An argument could be made that the current corporate leadership style in Ghana is the remnant of the perceived colonial style. Quite opposite to the traditional communitarian style in which leaders consult with elders before making a decision, the authoritarian

style of leadership (an alien leadership style) in which leaders dictate, seek no advice or input, and cannot be challenged now seems to be the norm (Adegbile, 2012; Okike, 2007; Amaeshi et al., 2006).

It is also possible that some elements of chauvinism is also involved, to the extent that having “to give account” to someone is also perceived as “unmanly”. An additional complication in Ghana is the fact that founders of private businesses not only continue to look at the organization, regardless of its size, as their “baby”, but also regard themselves as above regulations and everyone else including boards of directors. These dynamics make the study of corporate governance in Ghana a fascinating exercise.

Previous Studies

Because the topic until recently did not attract attention from business scholars, previous studies on corporate governance in Africa are sparse, and fragmented. Even more scarce are studies of corporate governance in Ghana. However, it is encouraging that a budding literature on scholarship on corporate governance is emerging on South Africa and Nigeria; the latter being the most populous and perhaps one of the most corrupt countries in Africa (Adegbite and Nakajima, 2011). It is also interesting to note that the corporate governance structure in Nigeria is quite similar to that of Ghana since the two countries experienced the same colonial leadership, and have inherited the same legal system from the United Kingdom.

One of the early studies on corporate governance in Africa was conducted by Rossouw et al., (2002). The study was a broad conceptual review of the theories of corporate governance which were related to the historical corporate landscape and the important developments which were taking place in South Africa. The authors make important observations on the continual evolving environment; from the South African Company Act of 1973 to the Johannesburg Stock Exchange (JSE) as it operated in the year 2000. Consistent efforts were made all through the paper to draw attention to the evolving financial and ethical dimensions of corporate governance in South Africa.

Following the large corporate failures in the USA and Europe which were attributed to “dereliction of efficient disclosure and corporate governance” a survey of corporate governance issues in Africa was conducted by Okeehalam (2004). The study assessed the “state of play” of corporate governance on the African continent in general. The author finds in his study that not only were there little or no academic research at the time on corporate governance, but there was also very few public documents.

Lamenting the dearth of relevant studies, Okeehalam (2004) observed that African corporations could learn valuable lessons from corporate failures in the U.S. and Europe and on the positive side, notes that “a number of private sector initiatives on corporate governance have begun to emerge”. Putting the early 2000 failures of U.S. and European corporations in context, Okeehalam’s (2004) study suggests that countries in Africa must be “efficient, effective, and have sound regulatory and legal framework” in place to advance corporate governance. While no one would argue with these suggestions, no follow up suggestion was offered on how these mechanisms should be implemented.

South Africa boasts the largest stock market in Africa, thus it is not a surprise that it was the subject of one of the early studies on corporate governance. West (2006) in an interesting and thought-provoking paper on corporate governance in South Africa provided a critique based on his analysis of the concept within the post-apartheid corporate environment. His analysis takes into consideration the existing socio-economic conditions and the espoused traditional African values and leadership style (the communitarian style) and relates them to the theories of corporate governance as well as its practice by corporations in South Africa. He arrives at the conclusion that there is incompatibility between the existing corporate environment and the espoused traditional African values. The author concludes that South African corporations value economic concerns over ethical concerns while the African values espoused by its leaders hold the opposite. He recommends a compromise between the traditional African values espoused by the traditional African leaders and the obsession over return on investments pursued by corporate leaders as a way to attract international investments which is greatly needed in Africa.

In rare study of its kind on Ghana, Abor and Biepkke (2007) examined the impact of the adoption of corporate governance structures on the performance of SMEs in Ghana. The authors limited their study to the financing implications for SMEs and used SMEs’ profits as the outcome variable. Abor and Biepkke (2007) find that such factors as the board size, its composition, management skill level, CEO duality, family business, and foreign ownership have significantly positive impacts on profitability. Thus, the authors suggest the adoption of corporate governance structures in general as the means for SMEs to overcome one of their perennial problems which is access to financing.

The study sheds light on an important issue which ultimately relates to employment or unemployment in Ghana, a country where SMEs employ a

disproportionately large percentage of the population (70% of the Ghanaian labor force according to Fredua, 2007; citing a World Bank Study), and make a significant contribution to the nation's Gross Domestic Product (Steel and Webster, 1991; Kayanula and Quartey, 2000). We note, however, that the study's operationalization of performance of SMEs in terms of profitability might be problematic as these figures, unlike stock prices that are formed from a consensus of market participants, are notoriously inaccurate in developing countries and Ghana.

In another study on Nigeria, Okpara and Kabongo (2010) examined barriers and issues that hinder effective corporate governance in Nigeria. Several barriers that have been identified include shareholders rights not being respected with minority shareholders in particular not being allowed to express their views. The ineffectiveness of boards of directors has also been identified as a major problem. The authors suggest that the ineffectiveness of boards is largely due to the appointment of incompetent or unqualified board members who are not committed to fulfilling their obligations. Furthermore the authors also discovered that even though extensive company laws and regulations exist on the books to protect shareholders and to govern the operation of corporations these regulations and laws are rarely enforced. Other barriers include ownership concentration, and transparency and disclosure. Even though Nigeria is the focus of Okpara and Kabongo's (2010) study, anecdotal stories and systematic evidence from other studies suggest that the findings are true in many other African countries as well (Rostow et al., 2002)

With the recent global financial crisis involving banks, coupled with the fact that the banking industry is a major source of finance for many SMEs in Africa, made the industry attractive to many business researchers. Olayiwola (2010) in his recent study examined the practice and standard of corporate governance in the banking industry in Nigeria using the Organization for Economic Co-operation and Development's (OECD) Corporate Governance Analysis Instrument. The study's findings are similar to those of Okpara and Kabongo (2010). It shows that Nigeria does have the institutions and the legal framework in place for effective corporate governance. Unfortunately, compliance and enforcement of the regulations are either weak or non-existent. This has culminated in the public's lack of confidence in Nigeria's banking system. The author suggests improvement of the enforcement mechanism and strengthening the role of the courts as means to improve the public's confidence in the banking system.

Adegbite and Nakajima (2011) in a recent study added to the budding discourse on corporate governance in the Sub-Sahara region by examining the nature, practice, complexity, the environment of governance and accountability of corporations in Nigeria. The authors find that the lack of transparency, dictatorial management style, and corruption are some of the major factors that militate against the proper functioning of corporate governance in Nigeria. The authors also find that pressures from investors “external” to Nigeria are being exerted to incorporate structures of corporate governance that have worked in developed economies in the ways in which corporations operate in Nigeria. While this may be a positive influence, the authors advise that Nigeria exercise caution in implementing “borrowed structures”. They further suggest that “borrowed structures” be reassembled in a coherent manner to meet the challenges” that are unique to Nigeria given its “historical, social, economic, political and cultural environment”.

Background to the Case Study

Ghana is considered by many as the gateway to, as well as a “pace setter” in Africa. Besides being the first African country, south of the Sahara, to gain independence from its “colonial masters” (Great Britain) in 1957, Ghana after years of post-independence political instability, has over the past thirty years enjoyed the most stable political and economic climate in West Africa.

As recently as the mid 80s, the university degree was regarded as one of the surest ways into the middle class in Ghana. The academic standards which were modeled after the British system were high. The university degree assured its holder of a middle-level management position, and the opportunity to help others (siblings, cousins, etc), in a country where the extended family system as opposed to the nuclear family system is practiced. Thus, competition to gain admission into one of the three government “owned” universities was fierce. Because of capacity constraints, thousands of students who otherwise satisfied the admission requirements could not be admitted. Not being able to enter the university to those who completed high school was not only a disappointment for them, but often to a whole family who may have pinned its hopes on this one individual. Often, it means also the loss of bragging rights to an entire village.

Against this backdrop one can understand and appreciate the decision, in the late 1980s, to open “ownership” of universities to the private sector in Ghana. These institutions would literally relieve the government of the

enormous pressure from the inability of the government-ran universities, due to capacity constraints, to admit many students who had otherwise met all the admission requirements. Private universities seem to have fulfilled this role very well as their numbers increased from 11 accredited in 1995 to over 50 in 2011 (Bemile, 2012; Varghesse, 2006). This number continues to grow as many buildings in Accra, Ghana's capital, are sporting signs of new and yet to be accredited universities. The university colleges that are not accredited, by law, cannot offer a degree program, therefore they limit themselves to certificate and diploma programs that are not highly valued in the marketplace. The fact that these schools still attract students attests to the desperate need for one to be educated beyond the high school level in order to have a chance at some form of employment.

The question that some commentators are asking, in the midst of this rapid growth, is how good is the quality of graduates of these universities? While this is a legitimate question given the fact that all the university graduates will have a role to play in building the future of the country, it is not addressed in this paper. Instead it focuses on two questions: to whom are the private universities accountable, and are they transparent with regard to their operations? These are legitimate corporate governance issues. Because the traditional corporate governance concepts deal with a system of controls, its focus is mostly on the principal-agent types of relationship; that is a relationship in which the owner of the organization is separate from the manager of the organization. The principal-agent problems are mostly eliminated when the owner of the organization also manages the organization. However, the essential question is whether accountability is no longer an issue when the owner of the organization also serves as its manager?

Quality Control and Governance Issues

Aware that a mechanism is needed to ensure the quality of graduates from the universities, both private and public, in 1993 the government established a National Accreditation Board (NAB) under the NAB Law 1993 (PNDDCL 317). The National Accreditation Board is an agency of the Ministry of Education, Science and Sports (MOES), the ministry responsible for formulating and implementing education policies.

The National Accreditation Board comprises 25 members who seemingly represent the major stakeholders in matters concerning education and the future of the country. It is headed by a chairperson who is appointed by the government. The Board's general responsibility is for furthering better

management and quality assurance of the nation's tertiary educational institutions. Specifically, it is responsible for the accreditation of the contents and standards of the academic programs offered by all the tertiary institutions in the country. The NAB discharges its duties through "committees and sub-committees that are responsible for institutional accreditation, program accreditation, and monitoring and supervisory roles to ensure the maintenance of accepted standards and availability of facilities." (The NAB, 2013)

The Board carries out its work through the use of questionnaires to elicit information and through site visits. These oversight activities are similar to those used by similar accreditation agencies in the United States. Thus, on the surface, it appears the Board should be able to satisfactorily carry out its charge.

There is also the National Council for Tertiary Education (NCTE), established through ACT 454 in 1993. This body does not deal with accreditation matters but is charged with the responsibility of advising the minister of education on all matters related to tertiary education in the country taking into account nation's resources, needs, and development programs.

The Structure of Private Universities

Not all private universities in Ghana are for-profit. While most of them are for-profit corporations, established by Ghanaian entrepreneurs and are therefore de facto SMEs, a few of the universities are faith-based (either directly established by a religious denomination or affiliated with one (for example, there is at least one Islamic University, a Methodist University, a Catholic University, Central University affiliated with the Church of Pentecost, Valley View University affiliated with the Seven Day Adventist Church etc)). A few of the private universities (non-faith based ones) are owned by foreign entities. It is important to note here that the term SME is defined differently by different organizations and also varies by industry. However, according to the European Union and the United States' Office of Small Business Administration an average SME makes an annual income of less \$50 million or 45 million Euros and employs less than 500 (USSBA, 2011; EC Europa, 2011). These are true of private universities in Ghana.

It is also important to note, before we proceed any further, that all the universities in Ghana, be it government, private, church-founded or affiliated, are open to the public. They admit students without consideration of religious faith, affiliations or background. Similarly, the employees

(staff and lecturers) are employed without consideration to their religious beliefs, faith or church affiliations. All the universities (including church-founded and/or affiliated universities) offer a broad spectrum of degree programs. The most popular programs include Business Administration, Information Technology, Counseling, and Computer Science. Naturally, the older government established universities offer the widest spectrum of curricular. However, because the graduates of all these universities become a unified resource of the country, there is a compelling argument for the government to monitor the academic standards of all the universities that operate in the country.

The organizational structure and the nexus of accountability of private universities in Ghana vary widely because of diverse ownership. However, they all have a commonality – they are all required by the NAB to have a mentorship affiliation with at least one of the three well-established government universities for a minimum of four years. The “mentor” institution also awards the degrees of the “mentee university” which is technically referred to as a “University College”. The “college” part of the name “University College” is dropped when the “University College” becomes a full-fledged university which is attained through a grant of a Presidential charter. Being awarded a Presidential charter is based upon a recommendation to the President of the Republic by the NAB via the ministry of education. In making its recommendation, the NAB must indicate that the university college has satisfactorily met all the NAB’s requirements and that it is capable of being autonomous. With the granting of a Presidential charter, full-fledged university awards degrees in its own name.

What exactly is the organizational structure of the private universities in Ghana? We posed this question because of the belief that a corporation’s organizational structure in some fashion speaks to its attitude towards its corporate social responsibility which is in turn related to the organization’s corporate governance issues. This point is implied in the viewpoint that holds corporate social responsibility as a self-monitoring mechanism through which an organization ensures its compliance with the laws, ethics and standards of its environment and international norms (Freeman, 2010). We argue that an organization that takes its corporate social responsibility seriously holds itself accountable to the public. This point is consistent with arguments previously made by Huang (2010) and Said et al., (2009) who also assert a link between corporate governance and corporate social responsibility. We searched existing web sites of the private universities

for an answer to this question. Because the NAB does not require the establishment of a particular form of an organizational form or structure as a condition for accreditation a wide variation exists. Even though we cannot conclude that the absence of evidence of an existing well-defined organizational structure at a web site is truly indicative that one does not exist, we believe that its absence or presence could be a signal of how seriously the university holds these values.

The church-founded or affiliated universities seem to be more likely to show the existence of a well-defined organizational structure that reflects accountability as well as transparency. Take the information we found at the web site of the Catholic University of Ghana as an example. It lists its principal officers as of 2013 as: His Eminence Peter Cardinal Appiah Turkson, Chancellor; Professor James Hawkins Ephraim, Vice-Chancellor, and Most Rev. Philip Naameh, the chairman of its boards of trustees. The board of trustees comprises 20 members including the chair. The institution, in addition to its board of trustees, also has a governing council comprising 14 members including its chair, and a university senate comprising 13 members including its chair. The membership of the board and the senate seems to draw on individuals with varied backgrounds. By most standards, this organizational structure is well-defined with in-built checks and balances. However, as a church founded university, the institution's leadership is ultimately accountable to the individual who is at the top of the church hierarchy.

The organizational structure described above contrasts sharply with what we found on the web site of for-profit private universities. Besides the fact that most of them did not reveal anything about their organizational structure, those who did seem to follow a format such as this: Principal Officers -The President some also carry the title of a CEO (President/CEO), Vice-President (Administration), Vice-President (Academics), Chancellor, and the Board of Regents.

The choice of title for the leadership of the private for-profit institutions is also note worthy. While the leadership of church-founded or affiliated universities is more likely to use the title "Vice-Chancellor", as used in the public universities, leadership of the private for-profit universities is more likely to use the title "President" or President/CEO. The President is also more likely the founder of the institution. Furthermore, the church-founded or affiliated universities are more likely to reveal the membership lists of either the board of trustees or their governing councils. This cannot be said of the private-for-profit universities which simply referred to the

existence of a board almost as an afterthought without even providing the name of its chair. We surmise that church-founded or affiliated universities are more likely to reveal these names because the members of their Councils and Boards serve for a known predetermined term which does not depend on the whims of the leadership of the institutions.

The fact that church-founded or affiliated universities are not necessarily led by the clergy may by itself generate the traditional principal-agency problems along the vein of Jensen and Meckling (1976) in which managers are separate from the owners of the organization. However, given their well-defined organizational structure this problem will be minimized if the boards function as they are supposed to, that is if the board members take their responsibilities seriously. Furthermore, because of their organizational structure, the leadership of these universities is more likely to take the duty to be accountable more seriously.

Unlike the church-founded or affiliated universities, the private for-profit universities are usually headed by their founder, an entrepreneur, who may have solely funded the organization, therefore the traditional principal-agent problems a la Jensen and Meckling (1976) as discussed above is absent. In this case the owner of the organization is also its manager; in other words, there is no separation of the owner from the manager – no principal and agent. The leadership of these institutions is therefore less likely to feel accountable to someone else. The absence of a description of a well-defined organizational structure on their web sites provides the basis for this deduction.

Corporate Governance and Private Universities in Ghana

The goal of corporate governance is “align[ing] as nearly as possible the interests of individuals, corporation and society” (Sir Cadbury, 2000). This view subscribes strongly to the proposition that there are interests beyond shareholders’ that may even be in conflict with each other, but which corporations must nonetheless try to satisfy. It is an endorsement of “**management – stakeholders**” model we discussed earlier. Satisfying this expectation does not appear to be a problem for faith-based private universities in Ghana because they, without any equivocation, see themselves as extensions of the founding or affiliated churches which embrace the philosophies espoused by Sir Cadbury above. On the other hand, there could be a conflict for private for-profit universities whose primary objective is to make profit (money) for the founder. Thus, the critical question is how do these for-profit universities discharge their

obligations to the society in which they exist while meeting the founder's goal of profit maximization?

To answer this question, one has to assess the performance of for-profit private universities on the four pillars of good corporate governance, namely "fairness, accountability, responsibility, and transparency" (West, 2006).

Honesty

Why should a corporation be fair and to whom, and above all how does this "fairness" requirement relate to private for-profit universities in Ghana? As discussed earlier, the expanded theory of corporate governance recognizes that corporations do not exist in isolation. Indeed, they exist in communities, and like open systems, draw resources and "nourishment" from their environment. Hence, they owe a duty to their stakeholders and not only to their shareholders (Freeman and Reed 1983). Because honesty is a cornerstone on which most religions are built, it is not difficult to see how faith-based and church affiliated universities will discharge this duty. However, stories reported in the news regarding the admission of students without requisite admission requirements raises concerns and questions (Modern Ghana, 2012; Kokutse, 2011). Are the private universities that engaged in such practices being honest to the society in general since their graduates will be working for societal good? Are they being honest to students who worked very hard and came into the universities with "proper" requisite qualifications? Are they sacrificing short-term gains for societal good? Do these universities treat those who work with them with dignity?

It would be difficult for the NAB to require "honesty" or as a condition for accreditation. Generally, the "market" must be left to police such conditions, however, the markets in Ghana are inefficient, particularly the markets for labor and education. Should self reporting be a way to go? If so, how would be done? These are issues that must be seriously considered by all the parties involved; the stakeholders and that should in fact include representatives of the students also.

Accountability

The failure of corporate leadership to hold themselves accountable is one of the major problems in corporate governance all over the world, but more so in developing countries. From anecdotal stories, this problem is acute and rampant with for-profit private universities in Ghana. Several reasons could be adduced to explain this: Firstly, the founders who most financed the organization are often at the leadership treat the university as a family business, thus they do not feel that they owe the duty of accounting to

anyone else – after all it is their money on the line. Secondly, because the owner-manager to a large extent mitigates the traditional agency problem that comes with the separation of managers from owners, many have also assumed incorrectly that the fiduciary duty the managers have are also eliminated in owner-manager setting and therefore the duty to be held accountable also disappears.

Even though the type attitude described above is common, it flies in the face of the extended view of corporate governance. While for-profit institutions may very well be a product of their founders' creation, because of the nature of their business (i.e., creating the nation's future resource pool), these owners owe a greater duty to the public. Besides the government is granting them a virtual subsidy by not competing with them, thus they are granted access to a large market share. Furthermore, because of rampant corruption is rampant in Ghana (see Transparency International, 2012), these owners need to constantly demonstrate that they are beyond reproach by being accountable to a third party. Who or what might this third party be? The answer to this question is a subject of debate nonetheless we offer our views on in the concluding section of this study.

Responsibility

This is a duty that is yet to be appreciated by many business leaders as well as the heads of private universities in Ghana. Being "responsible" generally denotes the sense that "one is liable to be called to account" (West, 2006) and therefore closely tied to accountability. However, we argue that one could feel "responsible" without necessarily having the duty of "being called upon" to account. We believe the leaders of corporations call on their employees to give their best efforts to make the corporation successful and competitive, therefore we can, on the theory of reciprocity, assume that the leaders must also be responsible for welfare of their employees. This argument applies regardless of where the corporations and what its business is, education or otherwise.

Anecdotal stories in the "blogosphere" on Ghana suggest (Modern Ghana, 2012) that most of the leaders of for-private universities dismiss employees (staff and lecturers) at will, and often for reasons no other than the fact that these individuals dared to question the wisdom of certain directives from the leadership. While the "employment at will" theory confers on the employer the right to terminate for no reason, and on the employee also to quit without reason, the real world operations, suggest that employers and employees owe each other better. This might be one of the reasons

that contracts between employees and employers even in the “right to work” environments often set aside the termination “without notice” aspect of the common law. Needless to say that “high turn-over” rate of employees, especially lecturers will not be helpful to students. Similarly, administration by intimidation does not make for a supportive workforce or institutional resource.

Perhaps, the NAB’s watchfulness over “turn-over” rates of employees and lecturers will indirectly induce adherence to the “responsibility” pillar of corporate governance.

Transparency

Transparency is an important principle of corporate governance and listed by all the well-known international guidelines for corporate governance such as the OECD, The Combined Code, and the Commonwealth Association for Corporate Governance (CACG). Disclosure is at the heart of transparency. Leadership of private universities must disclose as much information as possible about their operations. They can acquit themselves well by disclosing fully the names and qualifications of their boards of trustees. Furthermore, since the admission of non-qualified students seems to be the contentious issue now with the private universities (both for-profit and faith-based) as widely reported in the media (see Modern Ghana, 2012; Kokutse, 2011). It would put questions about packing their enrollments to rest, if they could at the beginning of every semester publish on the web sites, the lists of newly admitted students and their aggregates (qualifications).

Conclusion

Besides being a ticket to the middleclass, education is the best fight against ignorance, poverty and poor health. University education in Ghana means even more to the beneficiaries, given all the other intrinsic values associated with it. Denying otherwise qualified students the opportunity to access university education simply because of capacity constraints is not only morally unacceptable, but it also a “burden” that the “failed” student has to carry. For these reasons, private universities which came on the scene to solve the “capacity constraint” problem came to perform a valuable and needed service.

Indeed, given the high stakes involved for not getting into a university, one can easily make an argument the private universities in Ghana are discharging a social responsibility by merely coming into existence. However, the reluctance of the leadership of some of the private universities,

especially for-profit universities, to be transparent or to be accountable to a third party is troubling. Not only does that fly in the face of traditional African values as described by (see West, 2006), but it is also against principles of corporate governance.

We believe that through proper education, the leadership of private universities in Ghana will come to appreciate even more, the important role that they are playing in Ghana. At the same time, they will also realize that responsibility comes with accountability. One cannot take one and refuse the other; they must embrace both.

To nudge private universities to being accountable to all its stakeholders, we recommend that the NAB institute a requirement that: (1) all the universities have a well-defined functioning the boards of directors as one of the conditions for accreditation. (2) The boards of directors must comprise all the relevant stakeholders including employees, faculty, and students. (3) The boards must be required to have a minimum number of meetings per year. These requirements to some extent ensure that good corporate governance practices will not exist only on paper, but will also be truly put into practice.

Discussion Questions:

1. How can implementation of the four pillars of corporate governance help private universities in Ghana to become good corporate citizens?
2. Is there a connection between good corporate citizenship and the practice of good corporate governance?
3. Does culture matter in adhering to the principles of good corporate governance?
4. How can the NAB help the private universities in Ghana to develop good corporate governance?
5. Should the NAB play any role in the private universities' pursuit of good corporate governance?

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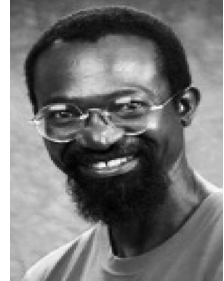
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BIOGRAPHY

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Chapter 19

Promoting Public-Private Partnerships through Innovative Governance Structures: The University of South Alabama Technology and Research Park

Robert A. Shearer & Jeanne D. Maes

Abstract

This case study describes how a public university with a traditional governance structure was able to overcome significant obstacles to collaborate with a high-tech company and launch the first regional academic-industry research and technical park through a public-private partnership. Through the contractual agreement of the public-private partnership, skills and assets of both sectors were shared, as well as risks and rewards, in delivering services and facilities for general public use. In this case, the parties were able to take advantage of a rare opportunity to marry academic resources and intellectual capital with private sector state-of-the-art software design expertise and production capabilities. This alliance set the stage for the steady growth and expansion of the Park that continues today.

Introduction and Background

Despite having invested significant time, energy, and creativity in strategic master planning, some organizations are unable to act quickly to take advantage of opportunities that arise unexpectedly. This case study describes how a public university with a traditional governance structure was able to overcome significant obstacles to partner with a high-tech company and launch the first true academic-industry research and technical park in the region via a public-private partnership.

Public-private partnerships are contractual agreements between public agencies and private sector entities through which skills and assets of each sector are shared in delivering services or facilities for general public use. In addition to sharing resources, the parties share risks as well as rewards (The National Council of Public-Private partnerships, 2012).

Background of the Creation of the USA Technology and Research Park

Neal Henderson, a Mobile, Alabama, entrepreneur and pioneer in the field of royalty-free, source provided market space, started Accelerated Technology, Inc. (ATI), a provider of real-time and embedded systems development software. In 2002, Mentor Graphics, an Oregon-based multinational corporation dealing in electronic design automation for electrical engineering, acquired ATI. As a condition of the transaction, Henderson agreed to stay with the company for five years and expressed his preference to remain in Mobile rather than relocate elsewhere within Mentor's global operations network. Consequently, he approached officials of his alma mater, the University of South Alabama (the University) a comprehensive doctoral institution with strong programs in computer science and engineering to explore possibilities of some type of partnership or collaborative venture. This initial collaboration started in motion a process that resulted in the creation of the USA Technology and Research Park (Park), now the focal point for innovative academic-industry ventures, public-private partnerships, and economic growth along the Upper Gulf of Mexico Coast. Committing 160 acres of its campus property to the development of the Park, the USA was recognized by the Mobile Chamber of Commerce as "Innovator of the Year" when the Park was launched in 2002.

Opportunities/Strengths

Developing a research and technology park had been an aspiration of university leadership from the time Gordon Moulton became president in 1998. This park concept was seen as an opportunity to promote USA's strong technology-based academic programs, to develop faculty collaborations and student internships with technology firms, and to advance the university's commitment to being an economic development driver for the entire region.

The Park was designed to have a market-driven focus for practical innovation. For the companies, opportunities included enhancing their reputations through a university affiliation; a ready source of talented employees; and blending research interests and expertise of university faculty and students with industry expertise.

For the most part, local government and business leaders embraced the prospect of attracting to the community more clean, high-tech industry to balance existing industries such as chemical and shipbuilding. Mentor Graphics and the other companies that would be recruited to the park would bring significant numbers of highly educated and well compensated

employees. The park concept would encourage high-tech entrepreneurial activities and generally promote economic growth and development.

Challenges/Risks

Along with the opportunities, there also were risks and challenges. From the outset, there was opposition from influential local private commercial real estate developers who complained that the tax-exempt public university's costs of recruiting high-tech firms and constructing state-of-the art facilities essentially were being subsidized by public funds, creating an unfair competitive disadvantage.

Resolving this conflict required considerable effort to educate the commercial real estate community about the unique nature of the university venture. The primary attraction of the Park for interested companies was the affiliation with a strong academic institution and the resulting opportunities for collaboration with faculty and students. Ultimately, the resistance yielded to the realization that absent the academic-industry connection, these firms would not have the same level of interest in locating or remaining in Mobile. Gradually, the private real estate community accepted the notion that the success of the Park would be the kind of positive indicator that would attract even more interest in the Mobile area from other companies considering relocation.

Other challenges involved developing a viable financial model and defining the business relationships between the tenant companies and the university. The financial issue was addressed by issuing construction bonds, with a rent structure designed to cover debt service and overhead costs of maintaining the buildings. As a result of productive negotiations led by Mentor Graphics facilities manager Dave Gardner and Moulton, the business relationships were addressed in a collaborative manner. Many of the specific terms were negotiated in tenant leases and reasonable guidelines for allowable use of the land and buildings in the Park. To provide additional incentives and create a sense of belonging to the university community, employees of companies in the Park were given many of the benefits of the university employees, i.e., tuition reimbursement (discount) for dependants, access to recreational facilities, library, athletic events, transportation system, the use of the university credit union, per-use fees for university research equipment, and easy access to inventions and technologies.

The few issues and conflicts that have arisen have been addressed in a collegial, "all-win" manner.

Governance of the Park

Launching the Park as a setting for academic-industry alliances that would serve the interests of the University faculty and students, high-tech industry, and economic interests of the region required a creative, collaborative governance structure. It was determined that a non-profit corporation – organized to forward the scientific and educational purposes of the University – would be the governance structure best suited to establish a viable public-private partnership. That structure would provide a legal governing entity not encumbered with many of the operating restrictions of a public university, such as competitive bid requirements and open meetings and records laws that might inhibit confidential negotiations with potential client companies. Consequently, the first step in creating flexible governance required the university board of trustees to agree to establish the non-profit corporation – the USA Research and Technology Corporation (USARTC).

The university's involvement in the operation of the Park lies in a carefully crafted governance structure. The bylaws of the USARTC provide for a board consisting of five members of the university board of trustees – four officers and one at-large member – as well as the university president and the vice president for financial affairs. Two other two directors, who are not officers, employees, or trustees of the university directors, are appointed by the USA board from a slate nominated by the USARTC board. The chair of the USA board serves as chair of the USARTC board, and the president of the university serves as president and CEO of the USARTC. The board of directors has adopted bylaws and entered into an operating agreement with the university. The board meets regularly to review and approve financial reports, receive staff briefings on current operations and prospective tenants, consider contracts, and generally exercise oversight of the USARTC.

The operating agreement between the university and that USARTC is the critical link defining the relationship between the two entities with respect to accounting, legal, management, and related services to the extent they are available and requested by the USARTC. The USARTC compensates the university for any such services utilized. This structure ensures that the leadership of the university and that of the USARTC are separate but work cooperatively to further the academic-industry partnership. Further, under this structure it is not necessary for the Park itself to hire employees, thus avoiding the expenses and risks normally associated with having a paid workforce. Services are provided by university employees through contractual arrangements as needed.

The governance structure facilitated the approval execution of the necessary ground lease and “fast-track” construction contracts for the initial building in the Park to be occupied by Mentor Graphics. Subsequently, taking advantage of the same structure, the university constructed a second building in the Park. As more companies expressed an interest in locating in the Park, the university transferred to the USARTC ownership of an existing recently renovated building that had served as clinical space for the university’s health care system. In 2012, there were seventeen companies located in the three buildings, employing some 547 people (K. Ferguson, personal communication, October 6, 2012).

In 2010, the USARTC governance structure again was central to the creation of NovALtech, a limited liability company that focuses on technology transfer and utilization, patents, processes, copyrights, formulae, and other know-how. NovALtech is solely owned and controlled by the USARTC. Though NovALtech, USARTC, and USA are separate entities, the legal structures and operating responsibilities of each ensure that they work together cooperatively to advance the teaching, research, and public service missions of the university.

Conclusion

By carefully navigating through obstacles posed by traditional governance models, the University of South Alabama was able to forge innovative public-private collaboration with Mentor Graphics Corporation. In doing so, the parties were able to take advantage of a rare opportunity to marry academic resources and intellectual capital with private sector state-of-the-art software design expertise and production capabilities. This alliance set the stage for the steady growth and expansion of the Park that continues today.

Some suggestions for other institutions that are considering such a venture:

- 1) From the outset, get buy-in from key members of the public institution’s board; provide enough information and professional advice to ensure them that the risk is worth the reward and that the governance structure can accommodate the public-private collaboration;
- 2) Convince economic development and civic leaders in the community to be champions for the project, and demonstrate the “win-win” possibilities of such a public-private alliance;
- 3) Develop a comprehensive financial model that does not put institutional assets at risk;

- 4) Engage and educate local developers early in the process so they do not see the Park as threat, but rather an opportunity to attract even more investment to the region.
- 5) Plan for growth and expansion, but maintain flexibility to address unanticipated opportunities.

Discussion Questions:

1. What are some initial steps that leaders should take in order to create collaboration among stakeholders? Who should be included in such collaborative arrangements?
2. What is the advantage of having a recognized public figure as the spokesperson and project advocate? Who is it here? Henderson?
3. Why is a clearly defined dispute-resolution method necessary to include in the public-private partnership contract?
4. What are some reasons that open, candid communication is vital for the success of a public-private partnership?
5. What are some factors that should be considered in selecting ‘partners’ for such a venture?

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USA Research and Technology Park



University of South Alabama, Research and Technology Park

BIOGRAPHY



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Chapter 20

MSME Governance: Can you tell me which way I ought to go from here?

Andrea Bather, Nirosha Hewa-Wellalage & Krishna Reddy

Abstract

The objective of this chapter is to provide an overview of the nature of corporate governance practiced by micro, small and medium size enterprises (MSMEs), highlight areas where there are gaps in the practices of governance and suggest strategies as to how those gaps can be filled. Owners of MSMEs are faced with many challenges, because of the need to work on the business and as well as working in the business. For this reason, MSME owners wear many different hats - those of director, manager, partner, operator, shareholder and sometimes creditor. Consequently governance may easily be overlooked.

Our findings support the view that MSMEs focus is on management and operations of the business and therefore, do not engage in corporate governance as such. Responses to our LinkedIn question support the view that engaging in corporate governance for MSMEs has been very difficult and to some, it is effectively a foreign concept. The implementation of sound corporate governance practices is not an easy process for MSMEs. It may involve a significant change in the way that firms operate and a shift in the distribution of power in relation to firm decision making. Moreover, implementing corporate governance in MSMEs is likely to be associated with the increased formalisation of firm processes and procedures.

Introduction

There are a plethora of studies that deal with the corporate governance practices relating to publicly listed companies, however, the nature of the corporate governance practiced by micro, small and medium enterprises (MSMEs)¹ is less understood. The most significant difference between

¹ Currently there is no universally accepted definition of a small firm nor is there an official New Zealand definition. According to the Ministry of Economic Development (*SMEs in New Zealand: Structure and Dynamics*, 2011), MSMEs are defined as enterprises that have 19 or fewer employees. However, when broken down by the size categories, micro firms are those with fewer than 5 fulltime employees, small firms are those having 6 to 9 fulltime employees and medium size firms are those with between 10 and 19 fulltime employees.

MSMEs and publicly listed companies is that the latter have separation and control issues and raise funds from the public, whereas the former are generally owner-operated or family-oriented companies which rely mostly on internally generated funds. Accordingly it is understandable that the focus of policy makers has been on compliance issues relating to publicly listed companies.

A corporate governance framework proposed by the OECD consists of three main elements: a set of relationships between company's management, its board and other stakeholders; a structure through which the objectives of the company are set; and the means by which attaining those objectives and monitoring performance are determined, together with proper incentives for the board and management to pursue objectives that are in the interests of the shareholders (OECD, 2004). In a wider sense, corporate governance includes the relationships with a broader range of firm stakeholders, both internal (employees) and external (customers, suppliers, etc.). In this regard, Tirole (2001, p.4) proposes a definition of corporate governance as "the design of institutions that induce or force management to internalize the welfare of stakeholders." Since no definition or framework of corporate governance practices exists that is relevant for MSMEs, it is important that MSMEs owners try and implement policies and procedures that provide a framework of how to conduct business and remain compliant with regulation. Furthermore, in competitive markets, all types of businesses have to be innovative and find efficient ways to reach customers in order to survive, and strategies for doing so overlap governance and management.

According to Banham and He (2010, p.79), "SMEs are expected to be the drivers of economic growth and providers of employment and investment options in many nations, including Canada, the US, and Europe and Australia." In New Zealand, the Department of Statistics reports that there were 469,120 business enterprises as at February 2012 (Statistics New Zealand, 2012). The survey conducted by the Department of Statistics counted businesses which met one or more of a specified list of criteria, including a mean employee count of more than three over a 12 month period, over \$40,000 of income in the last annual return, or expenses or sales subject to GST of more than \$30,000 (Statistics New Zealand, 2012). These statistics confirm the importance of MSMEs to New Zealand and to its economy. Moreover, the New Zealand Companies Office database suggests that the overwhelming majority (approximately over 95 per cent) of all registered companies in New Zealand are MSME (Walker,

Pekmezonic, Hanrahan, Ramsay, & Stapledon, 2009). This reflects the importance of MSMEs to the New Zealand economy, and it is thus in New Zealand's interest that MSMEs are soundly established and well managed and governed, and that the country facilitates the right environment for growth. Therefore it is vital for all types of companies to engage in effective corporate governance practices so that they can build good relationships and reputations with their stakeholders, manage risks and also strategise in order to be able to contemplate a long-term future.

A framework in the form of the principles and guidelines for corporate governance practices was promulgated by the New Zealand Securities Commission in 2004 with a view to improving corporate governance practices in all entities of economic significance in New Zealand, and to lifting economic productivity (New Zealand Securities Commission, 2004). This framework was not necessarily intended as being applicable to MSMEs, given principles referring to such issues as Board composition and audit.² Small companies could nonetheless benefit from considering the guidelines to such principles as ethics, risk management, and shareholder and stakeholder relationships.

We will, in this chapter, concentrate mainly on the concept of corporate governance, given that the company-form³ is the most widely used business form for MSMEs. So the question that needs to be asked is "whether corporate governance practices are relevant to the MSME type of business?"

According to Cadbury (2003), corporate governance is about controlling and managing a company. Since MSMEs often do not have boards in the same way listed companies do, the duties of control and management of the company are undertaken by the director(s), usually in close consultation with the shareholders. Under the Companies Act 1993, the director or directors cannot expropriate funds from the company's account, and must ensure the company is solvent at all times, but at the same time he, she or they are required to operate the company prudently and in good faith.

Both anecdotal (Ingley & McCaffrey, 2009) and empirical evidence (Brown & Caylor, 2006a, 2006b; Larcker, Richardson, & Tuna, 2007; MacAvoy & Milstein, 2003; Millstein & MacAvoy, 1998) relating to large publicly

2 Small businesses in New Zealand are not required to undertake audits of their accounts. However, if their constitution or founding documents require that accounts need to be audited, then these companies will have to comply.

3 However, it is to be noted that there are also a number of sole-trader businesses existing as well and a sole-trader business does not fall under the Companies Act 1993 and therefore, is not registered as a company. Under the Inland Revenue Department Act 1974 (hereafter IRD Act 1974), sole-trader operators are not allowed to claim wages/salaries from their business but are only allowed to make drawings. These drawings are not treated as expenses of the business but do have an effect on owners' equity. The IRD Act 1974 requires sole-traders to prepare financial statement for income tax and GST purposes. The tax rate charged on profits of the business activities is same as the owner(s) personal tax rate.

listed companies provides support for the view that good governance practices lead to improved financial performance. Furthermore, evidence shows that companies which have good corporate governance practices are more accountable and transparent, thus creating reputations amongst stakeholders that are bankable and investable (Bauer, Guenster, & Otten, 2004). It is acknowledged that good governance practices will not eliminate company failures, but if implemented, monitored and updated regularly, such practices will assist organizations to maximise use of scarce resources. The same rationale suggests that corporate governance practices in MSMEs will lead to lower levels of risk, and improve survival rates. Good corporate governance practices will also enable MSMEs to establish robust business processes that can increase future expansion opportunities.

Owners of MSMEs are faced with many challenges, because of the need to work on the business and as well as working in the business. For this reason, MSME owners wear many different hats - those of director, manager, partner, operator, shareholder and sometimes creditor. The work of governance requires MSME owners to both be forward-looking (that is, develop appropriate purposes, goals and strategies) and also, to take a 'helicopter' view over the present (to assure operational performance, compliance and stakeholder satisfaction). This means MSME owners must be objective, and also be critical of their own actions. For this reason, governance practices have always challenged MSME owners as it can be difficult to separate the decision-making role from that of the employee role, and also to separate work from personal life. Our LinkedIn survey (results provided in Section 4 below) provides support for the view that engaging in governance practices has been very difficult for MSME owners and that for some it is effectively a foreign concept.

Therefore, this chapter looks at the background to MSMEs in terms of the categories into which they fall, and legal frameworks around business formation, and explores relevant literature regarding the nature of corporate governance practiced by MSMEs in New Zealand. The importance of corporate governance practices for MSMEs and an alternative perspective of corporate governance pertaining to MSMEs are emphasised.

Background

It is not surprising that the immediate concerns of MSME owners are on management and operations rather than on governance. Arguably, these are the biggest shortcomings of MSME businesses which to some extent may have blinded entity owners from seeing the big picture, that is, where

will the business be going in the long-term, or answering the question “which way ought I to go from here”?

Considering that micro firms are owned by a single individual, the corporate governance framework for such entities is embedded in their daily work life. Therefore, MSME owners need to take steps or divide daily tasks in such a way that allows them to spend sufficient time on a continuous basis to think strategically about the business. Since there is no one set of corporate governance practices that will fit all types and size of companies, corporate governance in MSMEs need to be tailored according to the individual business type.

Table 1 provides a thematic framework that reflects the complexity of governance framework practices according to MSME category. The rest of the discussion in this chapter is focused on the corporate governance practices of category 1 and category 2 type MSME businesses.

**Table 1: WHAT GOVERNANCE PRACTICES
DO NEW ZEALAND MSMES NEED?**

MSMEs				
Category-01	Category-02	Category-03	Category-04	Category-05
Owned by a single individual (may be assisted by non-paid family members)	With employees other than close relatives	With several shareholders or partners (may be family members)	With a substantial number of shareholders	Listed on NZX Small Cap
- Simple accounts and system of internal control - Simple business/strategic plan - Simple set of performance indicators - Risks easily identifiable - Relevant and basic policies - Possibly external professional advice	- Formal accounting systems - A detailed business plan (3-5 years) and annual review - A number of performance indicators - Risk identification and risk management - External advice from professional accounting firm - A succession plan involving formal family agreement - Appointing governing director for the board	- Systems of internal control to support annual accounts - Clear objectives and plan - A written memorandum and articles of association – - Systems of performance indicators - A system to manage risk - An extensive network of policies and reporting systems - An accountable board and directors - Board to act in the interests of the company as a whole - A mechanism to ensure due performance by the board	- Processes and practices for category 3 in place - A sophisticated system to ensure on-going prosperity - Strict adherence to the principle of accountability - Shareholders Delegating power to the board to manage the company - Guideline for board composition and its operations - Board committees - Monitoring and helping management	- Processes and practices for category 4 in place - Listing rules and code of corporate governance practices of NZX

Taking these categories as the broad means of distinguishing between different types of MSMEs, one of the first, and in our opinion, most important questions for a micro or small business then becomes the legal form in which the business is to be conducted. However, a recent report commissioned by ACCA stated that “many SMEs do not take external advice at all on a number of issues, even from sources such as friends and family that cost very little to access” (Schizas, Jarvis, & Daskalakis, 2012, p.6). Marcum and Blair (2011, p. 144), argues that “an entrepreneur’s understanding of the legal impact of decisions on his or her business is a fundamental aspect of the start-up phase.” So it appears that legal form is not something that MSME owners take advice on, despite the vastly differing legal and personal consequences that follow the various options available to such businesses. In Marcum and Blair’s (2011, p. 144) view, “most entrepreneurs are not nearly as good at managerial and planning tasks (e.g., decisions on legal issues) as they are with creative tasks.”

In New Zealand, as in any other jurisdiction, business is bounded by a regulatory environment and cannot operate outside that environment. Thus the starting point for governance process is deciding the legal form for the business, because it sets the boundaries for what the business can and cannot do.

The most common legal forms of businesses in New Zealand are sole trader, partnership and an incorporated company.¹ The legal business structure used by a small or micro business is important because it determines the nature of the risks of personal liability arising from the business operations. Therefore, we argue that determination of the nature of legal form of business is one of the first governance decisions made by a business owner, even if it is not considered in those terms. Issues relevant to the business form include: ownership and control; capital; employment obligations; taxation; record keeping and reporting; termination; and legal compliance. Each these factors has different consequences on business and the business owner, depending on whether there is a legal separation of ownership from control or not.

Table 2 below provides a summary of the differences between a sole trader operated business, a partnership which is governed by the Partnerships Act 1908, and a company, which comes under the Companies Act 1993 in terms of some of these issues.

1 Other legal-forms of business are: clubs, charitable trusts, co-operatives, friendly societies.

Table 2: SUMMARY OF THE SIMILARITIES AND DIFFERENCE RELATING TO DIFFERENT BUSINESS FORMS IN NEW ZEALAND

	Sole Trader	Partnership	Companies
Formation	No legal formalities	By agreement, and if no written agreement, then provisions of Partnership Act 1908 apply	Companies Act 1993
Participants	One	Two or more	One or more
Name	Own choice except where limited by law	By agreement	Registered under the Act
Capital	Contributed by sole trader	Contributed by partners	Equity capital
Ownership of Assets	Owned by sole trader	Owned by partners jointly	Owned by company
Liability	Unlimited liability	Joint and several liability (personal)	– Company is liable. – Shareholders have limited liability
Constitution	None	Partnership agreement if it exists – otherwise Partnership Act 1908	May adopt constitution
Management	Self	Look to any agreement – otherwise equally by partners	Directors and employed managers
Auditing of Accounts	Not required	Not required	Required by Companies Act – but for non-issuer company may be waived by shareholders (unless a subsidiary or overseas company)
Termination	When business operations stop or on personal bankruptcy of sole trader	On death/departure of one of the partners, agreement or by operation of law	Put into liquidation by shareholder resolution or by Court on application of unsecured creditor under Companies Act

(adapted from Gerbic & Lawrence, 1991)

In a sole trader business, there is no separation between the business and the operator. Therefore, in sole trader businesses, owners have to have their own IRD number (which becomes the tax identifier for the business), are responsible for the tax return, the business accounts, all the day-to-day operational tasks and relationship building with stakeholders. If sales are above NZ\$60,000, then GST returns are required as well. The business affairs of a sole trader business are inseparable from the owner. A company on the other hand needs to do two of everything, one each for the director(s) and the business: that is, IRD number, tax return, accounting records and so on. Companies also require directors to be totally clear on when they are wearing a personal “hat” and when they are acting as director(s). Therefore, as the company gets smaller in size, harder becomes the differentiation between the two. In comparison, in a partnership

business, unless there is a written partnership agreement that provides for a different process, all decisions made need to be unanimously agreed. Each partner also becomes jointly and severally liable for all partnership debt, which must be paid for out of personal assets because any profits of the partnership are distributed to the partners who are taxed at their personal rate. Agreement must be reached between the partners if there is to be “business” assets and liabilities separated from personal assets and liabilities.

Anecdotal evidence provides support for the view that decision-making in the start-up phase of the business is mainly based on monetary values. The downside of early decisions being based on monetary values is that it negates the opportunities for a full understanding of the consequences of the decision in later stages (Marcum & Blair, 2011). The challenge for policy makers, Government departments, and advisors and consultants is to advocate the importance of the process of undertaking good governance practices from the outset.

Statistics New Zealand in its 2012 Business Demography Statistics Report noted that there were only 40,690 births of new companies in the 2011/2012 year, the lowest number of start-ups since the survey started in 2000. The number of enterprises that failed was 47,940 over the same period, so the number of deaths has exceeded births between 2009-2012. The total number of enterprises recorded as at February 2012 was 469,120, of which 69% do not have employees. It is also interesting to note that although the annual death rate of enterprises in New Zealand is more than 10% (Statistics New Zealand, 2012), sole enterprises had both a higher “birth rate” (11%) and a higher “death rate (14%) compared to businesses with employees. In addition, over a 10 year timespan, only one in four sole operated enterprises survived, compared to nearly half the enterprises employing 6-49 employees.

These statistics paint a very telling picture, and highlight the need to find a way to educate businesses about governance. If only one in four micro businesses survive 10 years or more, then the manner in which the business is governed must be reconsidered. Therefore in addition to prioritising the legal business form, business owners need to especially focus on the wider issues relating to governance, and long term strategic planning, which are integral to sustaining and growing the business.

Literature Review

The issue of effective leadership of small and entrepreneurial firms has been the subject of recent discussion and debate around the world (Brunninge, Nordqvist, & Wiklund, 2007; Daily & Dalton, 1992). Particular focus has been placed on those individuals most directly responsible for firm activities, such as owners and top managers (Daily, Dalton, & Cannella, 2003; Daily & Dalton, 1992). In addition, many organizations and countries have recently attempted to introduce corporate governance codes and practices for MSMEs, given their importance to their economies. For example, the European Confederation of Directors' Associations (EcoDa) (2010) introduced corporate governance guidance and principles for unlisted companies in Europe. This publication provides a major step towards helping European unlisted companies address the issues involved in designing an appropriate governance framework. Furthermore, countries in Asia and the Middle-East have also designed corporate governance frameworks to support and guide the development of corporate governance practices in small companies. The corporate governance code for SMEs in Dubai mainly focuses on issues of growth and sustainability (The Corporate Governance Code For Small and Medium Enterprises, 2012). The Guidelines on corporate governance for SMEs in Hong Kong encourages development of corporate governance for SMEs as well ("Guidelines on Corporate Governance for SMEs in Hong Kong," 2011). Despite this and much related work, ambiguity still remains regarding the corporate governance practices of MSMEs. There is also the problem for small enterprises given the continued academic focus on the centralised corporate board governance practices of large firms as a model for all companies, rather than on developing practices that are specifically relevant to MSMEs.

Limited data availability for research relating to corporate governance in smaller firms has undoubtedly contributed to the limited literature concerning governance practices in such firms. Prior research on corporate governance in such firms has focused specifically on the role of the boards (Daily et al., 2003; Farrington, 2007; Finkelstein & Mooney, 2003; Gabrielson, 2003; Heuvel, Gils, & Voordeckers, 2006; Martin, 2004; Segaro, 2012). However, we consider that the board of directors is only one aspect of the corporate governance framework. As well, formal board structures do not exist in many smaller firms and if they do, their contribution tends to be negligible. Survey results from Hessels & High (2006) show that for Dutch SMEs with between 1 and 99 employees, only 3 per cent have boards of directors. Therefore, there is a need to broaden the perspective of corporate

governance practices, especially privately held firms. For example, Uhlaner, Wright, & Huse (2007) adopt a broader perspective of corporate governance in privately held firms in the Netherlands, considering the roles of owner, financial reporting and auditing, and executive remuneration as well as other governance mechanisms. They also consider privately held firms in different life-cycle stages and their respective governance structures and mechanisms and acknowledge the importance of corporate governance in closely held small and medium-sized enterprises.

Since most MSME's are closely held and are owner- operated (Bennedzen & Wolfenzon, 1999; Brunninge et al., 2007) the unification of ownership and management roles leads to pressure for accountability, transparency and strategic renewal (Carney, 2005). But for New Zealand, arguably, there is a need to develop corporate governance frameworks that take into account the requirements of the Companies Act 1993 with respect to the roles of directors, while allowing for entities which do not necessarily have clear board structures. Agency threats can also arise because the interests of the manager/director may not necessarily coincide with those of the extended family and other owners; the lack of separation between ownership and control may lead to a reduction in formal safeguards; family involvement may lead to adverse selection of employees; and altruism towards family members can lead to inefficiencies (Anderson & Reeb, 2003; Gomez-Mejia, Nuñez-Nickel, & Gutierrez, 2001; Schulze, Lubatkin, & Dino, 2003; Smith, 2008).

4. What should corporate governance practices in small firms look like?

Corporate governance is, we understand from both our experience and the literature, not common in the MSME business setting in the same sense that it applies to businesses raising capital from the public. After all, the term “corporate governance” is generally associated with large, publicly listed companies that are required by law to manage and disclose how board members and executives make decisions (Mohr, 2010). Our position however, is that the establishment of effective corporate governance practices which define the firm's approach to each of these issues is of equal importance to unlisted small firms, whether companies or not. The European Confederation of Directors' Associations (2011) reported a number of reasons why MSMEs should specifically concern themselves with corporate governance, these being to increase performance and internal efficiency, to deal with capital and illiquidity risk, and building corporate reputation in line with societal expectations.

Indeed, the development of effective corporate governance mechanisms may lift a significant burden from the MSME's owners, facilitate swift

succession, and allow access to wider pool of expertise and know-how. In turn, this should lead to an increased strategic vision of the firm, decision making and risk management, particularly as the entity grows in size and complexity. In addition, governance will also become a highly relevant issue for MSMEs as they access new sources of external finance, such as banks, venture capital and private equity. Initially, the primary source of capital is likely to be contributions from owners, retained earnings or financing from internal networks, such as quasi debt/equity. External funders however tend to favour companies that have more explicit governance frameworks which can give assurance that their investments will be well managed. Furthermore, effective corporate governance practices also provide a means of mitigating risks associated with ownership disagreements and/or disputes. Good corporate governance also provides a “mandate to operate”; since it offers stakeholders’ assurances that the MSMEs operate in an appropriate and responsible manner enabling key stakeholders, such as financiers, employees, customers and local communities to contribute to and be part of the MSMEs successes. Regardless of company size, listed or unlisted, public opinion is now towards appropriateness of corporate structure, procedures and behaviours.

To further understand what micro and small businesses think about governance, a statement was posed to the LinkedIn group New Zealand SME Business Network. The group was established in November 2011 and has 2961 members, who are a mixture of owners, directors, managers, partners, vice-presidents and seniors (www.linkedin.com/groups). The statement was put in these terms: “Hi everyone. I am currently doing some research into micro and small/medium business governance, with an emphasis on micro and small entities. I would be interested in your thoughts”. In all, 15 comments were received, from six separate responders, who were a mixture of business owners, consultants and one who was involved in business education. There was no prescription concerning expected responses, we simply wished to obtain views from those operating in this sector.

One business owner noted “I was trying to find out what you meant when you said governance, particularly in a small company with no board. I cannot find anything in the Companies Act that speaks of the requirement to govern or for governance”. The point is an extremely relevant one, because the Companies Act does not use the word or concept of “governance”. The Companies Act 1993 (s128) requires company directors to undertake the management of the company, or oversee and supervise the management

of the company, rather than govern the company. The problem with such a direction is that historically “corporate governance” has been a concept emanating from management theory and literature, which has legal overtones, but the concept has now been adopted by the Courts as a benchmark for judging the actions of the director(s), so it is surprising that there is no mention in the Act. Another business owner stated:

“I think governance is a focus for owners of even the smallest businesses even if they don’t know it. They aren’t in the habit of using that particular word and could at worst be accused of losing sight of the high level view, concentrating more on day to day responsibilities”.

Such a demarcation is often referred to as the difference between working on the business, as opposed to working in the business (our emphasis); effectively doing whatever it takes to earn the money from which a profit is derived. So there may be an issue of terminology for some business owners, with the practical implications of the two concepts being regarded as encompassing different matters. According to the OECD, “The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board’s accountability to the company and the shareholders’ (2004, p.24).

Where the company form is chosen, some detail in terms of management obligations is however provided by the Act. Under the Companies Act 1993, the director or directors cannot expropriate funds from the company’s account, and must ensure the company is solvent at all times, but at the same time he, she or they are required to operate the company prudently and in good faith, with due skill and care being applied (Companies Act 1993, ss131-137)

Explicit in the Long Title of the Companies Act is the message that one of the Act’s purposes is “to define the relationships between companies and their directors, shareholders, and creditors” (Companies Act, 1993). This can be done for an individual company by way of a constitution, and a shareholder agreement, but there is no obligation to create these governance documents. One of the business owner respondents to the statement posed said

“Governance usually concentrates on agency issues; it’s about putting mechanisms in place so conflicts of interest between shareholders and managers are identified and resolved. This isn’t usually a problem for micro businesses where the owner and manager is the same person. Of course governance isn’t a word normally used in connection with tiny businesses”.

On the same issue, another responder who is a management consultant noted:

“... my experience with micros is that they are 90-100% concentrating on the here and now of operations; sales, customer service, money, time management and staffs consume their focus and activities. In the cases where a business coach like me asks them to set aside x hours working ‘on’ the business vs. ‘in’ the business- such time is spent on overall strategy, systems review and performance review. Only occasionally does their relationship with key stakeholders (other than customers) come into the picture.”

Businesses cannot survive without stakeholders – shareholders, customers, suppliers, employees, and even competitors are common stakeholders for a business, so relationship management is an essential part of governance for a business. If a company is formed, the immediate relationships are as noted above, the company itself, as a separate legal entity, the directors and the shareholders, and then creditors whose support is needed. Thought must be given to how those initial sets of relationships will be managed – those decisions are governance in action.

Partnerships are not so rule-bound in terms of governance and management. The Partnership Act 1908 defines a partnership as “The relation which subsists between persons carrying on a business in common with a view to a profit” (Section 4). A written partnership agreement is not compulsory, so the parties may have only vague agreements of their intentions. Effectively the rules which apply to a partnership are that where a partner or partner appears to have the authority to do something which will impose obligations on all the partners in the partnership, then that obligation is binding on the partners. When obligations are not met, the Partnership Act then provides creditors the option of suing one, some or all of the partners for the outstanding debt, and the partners then must resolve the issue of liability amongst themselves. This is known as “joint and several liability” and under the Partnership Act is unlimited (except for special partners), (compared to shareholders in companies who have limited liability – their personal loss cannot be more than the value they have put into the company for the purchase of shares). A Partnership agreement can set some boundaries around roles, powers and liability questions, but forethought is required to make such decisions. Sole traders, of course, have only themselves and their personal resources to call upon, but are still capable of making governance decisions for their businesses, in such areas as business plans.

We agree that many MSMEs are undertaking governance processes, even where they do not know or use that term. Creating and overseeing relationships and governance documents, setting goals, preparing a business plan and the necessary strategies to fulfil the plan, succession planning and identification and management of risks are concrete examples of governance decisions made by business owners, even if not referred to in that sense.

Practical Implications

The implementation of sound corporate governance practices is not an easy process for MSMEs. It may involve a significant change in the way that firms operate and a shift in the distribution of power in relation to firm decision making. Moreover, implementing corporate governance in MSMEs is likely to be associated with the increased formalisation of firm processes and procedures. Many of those involved with MSMEs may see this as imposing an unnecessary bureaucratic burden.

The one major barrier in implementing corporate governance practices in MSME is a lack of internal corporate governance know-how as to how to start the process, as well as, in our opinion, the access availability of external qualified advisors. One source of advice is The Organization Development Institute in New Zealand which provides a wide range of training and development programmes, including a programme of MSME governance workshops for MSME owners. These workshops, run throughout New Zealand, are approved for the New Zealand Department of Trade and Industry's Capability Development Voucher Scheme. Such advice could be the first step in achieving awareness of the important role of governance in securing a growth path for the organization. Seeking advice by such means will help to tease out the distinctions between governance and management and highlight the actions to be taken under each 'hat'. Business advisers, independent directors and mentors can also provide external and objective views of MSME governance, management and day to day operations, in order to help create the right frameworks for each of the tasks required to run the business.

Small business governance requires taking time out from day to day operations to get the right practices in place. Benefits of governance can often be gained without new structures or significant additional cost. For MSMEs, board meetings need not be structured, cumbersome, expensive or time-consuming. Meetings should be incisive, value creating and timely, but most of all, recorded.

Figure 1 provides a list of tasks performed by MSME owners which are common to the list of tasks performed by a structured board (if one exists in a company) and/or companies that undertake corporate governance activities. Although these tasks are not labelled or regarded as corporate governance practices, it does not mean that such activities are not undertaken or not important. Most importantly, Figure 1 not only highlights the nature of corporate governance practices for MSMEs, but also confirms that all types of businesses undertake corporate governance practices/activities in some form or another.

Figure 1: MSME CORPORATE GOVERNANCE



Discussion Questions:

1. Is corporate governance relevant to MSMEs?
2. List at least 5 areas, issues, problems or delegations that you consider would fit with the heading MSME governance?
3. How does governance of MSMEs' differ from governance in listed companies?
4. What are the challenges, barriers or constraints faced by MSME owners in implementing corporate governance practices?

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Chapter 21

Governance Practices in Action. Ways to Support Family Business Development

Alessandra Tognazzo, Martina Gianecchini & Paolo Gubitta

Abstract

Family firms are unique because one or more families are at the apex of the firms' governance institutions. Consequently, the most important influence is not necessarily exercised by an individual, but rather, by a group of people who are linked to each other by blood, marriage and affective relations. As a result, the allocation of power within the family, the interaction between family members and other stakeholders, as well as family characteristics (such as size, age, and history) are likely to have a determining impact on organizational processes. This chapter explores the governance implications arising from this set of characteristics and offers tools and recommendations as to how those characteristics can underpin an appropriate and responsive governance process.

Introduction

In terms of governance, a major challenge is to identify the distinguishing characteristics of family firms relative to other firms. Family firms are unique because one or more families are at the apex of the firms' governance institutions. Consequently, the most important influence is not necessarily exercised by an individual, but rather, by a group of people who are linked to each other by blood, marriage and affective relations. As a result, the allocation of power within the family, the interaction between family members and other stakeholders, as well as family characteristics (such as size, age, and history) are likely to have a determining impact on organizational processes.

As compared to their non-family counterparts, family businesses have some distinctive advantages. For instance, family labour or family capital provision may be less exposed to information asymmetry or opportunistic behaviours, because interests between owners and managers are aligned. In other words, ownership concentration may alleviate the agency problems.

Also, family interactions may facilitate screening and enforcement of contracts, firm-specific investments and reputation building. Nonetheless, the joint maximisation of family and business objectives, may also entail significant distortions to firms. For instance, one problem might be that families may steer firms towards decisions that favour them at the expense of minority shareholders (Corbetta & Salvato, 2004).

Usually governance best practices are not designed with family businesses in mind. For example, the classical agency theory (Jensen & Meckling, 1976; Fama & Jensen, 1983) suggests that the main task of the board of directors is to control managers' actions to avoid opportunistic behaviours (Muth & Donaldson, 1998), which could be counterproductive in a family business where board members might be managers' relatives. A family business looking to secure its future, needs to acknowledge the particular challenges created by family involvement. Moreover, the fact that both family business practitioners and scholars have been worrying about governance for so long suggests that they have distinct challenges that require further thinking.

As a matter of fact, a family firm is a mixture of business, family and ownership concerns that can make these three systems emotionally rich environments for planning and decision making. In these systems individuals must manage issues within and across three overlapping groups: the family, the business, and the ownership system. The so called "institutional overlap" (Lansberg, 1983) among the three groups often leads to differing points of view among individuals also depending on their location in the three circles. For example, family members who work in the business often have different opinions about the proper level of dividends than do family shareholders who are not employed in the firm. All these divergent perspectives are typically legitimate and must be reconciled in a respectful way to preserve harmony in the family and to reach the desired objectives of the business. To effectively manage business and to avoid firm breakdown, family and ownership concerns requires a special attention towards planning the governance structure of the organization.

Statistics on the long-term survival of family-owned firms are alarming. Based on U.S. figures, Birley (1986), Ward (1997) and Kets de Vries (1993) showed that about 10% to 15% survive into the third generation. More recently, according to a survey (2010) of more than 1,600 family-owned or managed businesses around the world, 27% expect to change hands in the next 5 years, but 47% of the companies surveyed had no succession plans in place; also 34% of companies based in North America expect to

bypass their families altogether for succession and sell to key employees or outsiders.

The challenges and resistance around planning in many family businesses have resulted in some even more unfortunate statistics: only a little more than 30% of family businesses survive into the second generation even though close to 70% would like to keep their business in the family; by the third generation, only 15% world-wide are typically still viable, according to a U.S. Trust, Bank of America Private Wealth Management study; by the fourth generation and beyond, only 3% of family businesses continue to exist.

All these statistics tell us that for most family held businesses, planning for the future is the toughest and most critical challenge they face. Yet, planning can also be a great opportunity to maximise opportunities and create a multi-generational institution embodying the founder's dreams and values which can foster firm prosperity. Family businesses may consider different corporate governance practices which can be adopted to sustain business growth.

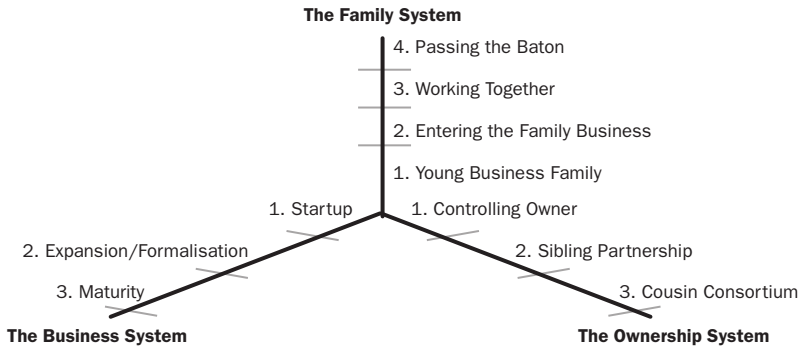
In this chapter we will first describe what we mean by family business growth, then different governance strategies will be presented which can be applied by family business practitioners analysing both advantages and disadvantages of these practices.

Family Business Development Stages

The corporate governance solutions which family businesses can adopt will vary depending on the stage of business development and controlling family ownership. Some practices are appropriate when a single person, the founder of the company, is in charge of the firm. Other structures and processes are better suited when the next generation takes over the business. And a third set of governance solutions are adapted to companies controlled by family members of later generations.

Developmental models for family businesses describe the stages of various family business elements, including the founder, the family, work relationships, the business and ownership. Besides many frameworks explaining the lifecycles and stages of business organizations (e.g., Churchill and Hatten, 1987) and Ward's pivotal framework (1991) explaining ownership stages in family business systems, the major developmental framework for family business systems is that developed by Gersick, Davis, McCollom and Lansberg (1997). This framework, widely accepted by scholars, and illustrated in *Figure 1*, helps to understand the evolution of family firms.

Figure 1: THE THREE-DIMENSIONAL DEVELOPMENTAL MODEL OF FAMILY BUSINESS



Source: Gersick, Davis, McCollom and Lansberg (1997), p. 17

Looking at the ownership system line, it can be noticed that the initial phase – in which all dimensions are concentrated in one family, groups of families or in an individual founder – is known as the “founders’ stage.” As time passes, the company grows and the ownership shifts to the next generation, a stage called the “sibling partnership.” As more time goes by, the company is taken over by future generations, reaching maturity. This stage is named the “cousins’ confederation” stage. When the business reaches maturity, according to the model, the challenge is to have tolerance and faith in the planned transition for the company to continue.

Transferring the values and business knowledge of the founders to future generations becomes more difficult as the family grows. The challenge is to keep all family members belonging to different generations united and their interests aligned over the years. When families reach the third and fourth generations, their members may barely know each other. Moreover, as the founding generation ages, succession and power issues across an expanding family may create cascading concerns, especially since the demand for the creation of wealth for future generations increases as time passes. How can a family maintain a shared vision about the company and family harmony? All sorts of diverging views might arise: on ownership, on the degree of control which the family intends to retain or on the family involvement in the company’s governance either through the board of directors or the executive management. The governance structure can be extremely helpful when it comes time to discuss sensitive issues, for instance ownership shares, rights and responsibilities, competencies of family-member managers and the best strategies for both the business and the family.

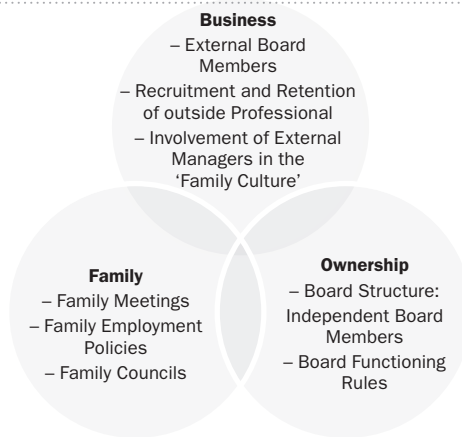
Conventional business governance often focuses on defining the boundaries of decision-making power, while practices of family business governance are often focused on establishing active engagement of members. Procedures which provide participations and consultations among owners, directors and managers assure an ongoing alignment of interests and objectives over time. In this way, all parts of the family business system are focused on creating value together. Yet, good family firm governance requires more than the participation of active owners, in particular it requires building a clear and shared understanding of the separate functions of the ownership. Board and management are a critical part of effective family business governance, especially when family members have multiple roles as owners, directors and managers. A well-functioning system contributes to building trust within the family, which is in turn an asset to the organization. This spiral of trust is a relevant factor in supporting the decision making process and overcoming the potential complications arising from the direct involvement of the family on multiple levels.

Modifications in family scale are a common cause for the evolution of the management governance system in the context of family firms. As business grows and becomes more complex, the demand for a more formal organizational structure increases. The ability of a family business to face these challenges is strictly related to the probability of success. In other words, since both family stages and business life cycles often challenge the effectiveness of existing governance practices, family companies are confronted with the need to redesign their business governance. The evolutionary stages of family businesses can lead to fundamental modifications in the roles, functions and practices of the management and governance systems.

In other words, in order to prevent potential conflict and ensure continuity, a critical factor in family business life-cycle is represented by the governance system adopted (Neubauer and Lank, 1998). Developmental models for these businesses present some unique challenges due to the complexity of the relationships involved. Business growth is accompanied by both family evolution and ownership modifications. By taking into consideration all these aspects, the aim of this chapter is to review and systematise the main practices which may support family business development. As shown in *Figure 2*, the analysis will focus on main issues related to the three most important systems usually identified as essential components of family businesses. First, attention will be paid to some elements concerning the

role, structure and composition of the management team and the board of directors in a family business, as it grows in size and complexity. The focus will then shift to governance practices which may be useful to maintain a shared vision and aligned interests.

Figure 2: PRACTICES WHICH SUPPORT FAMILY BUSINESS DEVELOPMENT



Management Professionalisation Process: The Key for Business Growth

“The first generation builds the business, the second expands it and the third destroys it”: it is a universally acknowledged phenomenon that few family-owned businesses survive beyond the third generation. While most business owners are highly successful in building and managing their companies, they are often less successful when it comes to passing their enterprises from one generation to the next. As stated earlier, a family business typically passes through three stages: the controlling owner stage to the sibling partnership stage and then to the cousin consortium stage.

Professionalising the business is generally considered to be a necessary step in family business growth. Professional managers differ from family ones in the following respects. They have typically received formal training in a business school setting in specific management areas such as finance, production, accounting and human resources. Their actions should therefore be driven by a set of general principles independent of the particular case under consideration, they should be experts in a particular field of management and their relationships with clients should be considered helpful and objective. Normally, these specialists gain status

by accomplishment as opposed to status based on ties to the family and they belong to associations of fellow professionals (Schein, 1968). This is not to say that all those who receive management training are necessarily professional managers. For example, those who receive management training but have a technical background may still view themselves as primarily technical experts rather than managers. Their actions and implemented management practices make them professional, rather than not.

Yet, professionalising the family business might be considered a misnomer. "Family business" does not necessarily connote an unprofessionally-managed firm. Arguably then, it is inappropriate to characterise an organization as either family-run or professionally-run (but not both) as family members can be professionally trained and competent in their area/areas of expertise. However, professionalisation can refer to the management professionalisation process. Including non-family members in the top management team can provide critical skills to the business, especially when succession problems arise (e.g., siblings rivalry, lack of dedication of the next-generation members, etc.). They can help to govern the relationship between family and management and are essential to the health and continuity of family-owned businesses (Poza, 2010).

The three main issues related to professionalisation in family businesses are, a) the decision on whether and who to include as external members b) the methods used in attraction and retention and c) the arrangements which allow them to be successful contributors in the business. These three issues are discussed below.

a) The decision on whether and who to include as professional managers

The decision to include external board members, and in particular a non-family CEO, should be contingent on the particular needs and opportunities faced by the business, the family's preferences and the skills which are present/absent in family-member candidates. In particular, a family firm should consider involving an outside CEO when the CEO of the outgoing family is not capable of leading a succession process and/or choosing among the children they love equally. When there are no successors qualified to carry out the chosen strategy, for instance when potential successors are too young, a world-class outsider could be both a role model and a provider of substantive mentoring in their developmental process. Another motivation for nominating a non-family CEO can be acknowledgment that the business needs a leadership able to focus on the future – and not on the past – or more generally if the business needs a

dramatic change and the owning family has to deal with both the need for change and its desire to keep the business under family control, therefore preferring this option to a direct sale of the company. Some leaders of family firms believe that the family's lack of professionalism and the employees' lack of concern for profitability and efficiency can be changed by indoctrinating the current leading team in sound business practices or by bringing in professional managers whose values are more consistent with organizational efficiency and achieving higher profits. Leaders of family firms who have a paternalistic orientation towards their employees are often reluctant to make such changes themselves. They hence bring in "hired guns" to make the painful changes the family would not make.

Besides the most radical and revolutionary decision of bringing outside professionals in the company, there are other basic options which can be associated to those leaders of family firms who wish to bring professional management skills into their organizations. Family members could decide to professionalise members of the owning family or to train non-family employees currently working in the business. Taken alone, these two options represent more evolutionary and incremental changes in the methods of doing business, that is, changes will occur rather slowly over a number of years (Dyer, 1989).

The process leading to the selection of non-family executives has both a supply and a demand side. On the one hand, as in every other business, the demand side has to deal with "match ups" occurring during the recruiting process: (1) individual talent with organizational talent requirements and (2) "individual needs with the need-fulfilling characteristics of the job" (Wanous and Lawler, 1972). In the human resource management context these "match ups" are known as the "person-job fit" and "person-organization fit" (Kristof-Brown et al., 2005, p. 284). What is special about family businesses is that, with regard to the selection of potential candidates, family members need to devote particular effort in evaluating the social skills of the potential candidate. Indeed, family business owners often expect cultural fitness, sensibility to deal with family issues, understanding and the sharing of family values and interests out of an inner belief, trustworthiness, courage, credibility, reliability and humanness. The candidate must fit into the composition of the management team. They have to demonstrate a mature personality by displaying self-confidence, authority and modesty. At the same time, the candidate should be loyal, ready to subordinate to and compromise with the family. Professional skills such as practical and leadership experience, industry knowledge, a

sure sense of money and risk, entrepreneurial engagement, correctness and transparency are important (Becker et al., 2005). An external manager should be able to build credibility and consensus on the board and among shareholders regarding new business plans and proceed with a sense of urgency but slowly enough so as to incorporate traditional values and established core competencies of the family business into their plans. Communication skills are extremely critical because in order to achieve these goals they should provide detailed and timely financial as well as operating information to all shareholders and eventually groom their own successors, ideally a next-generation family owner-manager. They should do so by putting in action all the strategies which enable them to avoid the risk of feeling they are the ones who dare to criticise those who could be their bosses in a few years or who own the company now (Poza, 2010).

On the other hand, the supply side is the potential and evoked set of executives and their characteristics and selection criteria are important aspects to consider. What exactly motivates prospective executives to accept or reject a position as an executive in a particular family business? This issue will be considered in the next paragraph.

b) Methods used to attract and retain outside professionals

The most basic and effective means of recruiting and retaining high-quality executives is to offer attractive compensation packages and career options. Nepotism has no place in a family company as some non-family executives feel at the mercy of the owner's good will with regard to both fairness and compensation level. A merit-based and professionally run family-business culture is essential (Poza, 2010).

Empirical evidence agrees that family-controlled firms pay less compensation to professional managers (Allen, 1981; Lew & Kolodzeii, 1993; Morck, 1996). Family leaders need to develop compensation packages to retain non-family managers and incorporate them to buy into the family vision.

Compensation packages might include various incentives to attract and retain a non-family executive – e.g., shares of the family business, direct or indirect compensation, emotional or social compensation or other incentives (McConaughy, 2000). Yet, research shows that only few family business owners allow non-family members to have shares in the family business (Hennerkes, 1998; Aronoff and Ward, 2011). Other indirect incentives may include a pension plan, health insurance, disability insurance or life insurance. Non-family executives also appreciate a termination agreement including vesting schedules or termination payments (Astrachan et

al., 2002). Compensation may also consist of incentives such as career options, emphasised merit or other benefits which increase the non-family executive's confidence and self-esteem. Detailing all these rules and policies on employment and family-business relations in a family constitution can help to make family businesses more reliable and trustful to the outsiders' eyes (Poza, 2010).

Family businesses may offer different compensation packages comparable to those of public companies, because emotional and social compensation as well as psychological ownership can be relevant issues in these contexts (Astrachan & Adams, 2005). Recent research (Memili, Misra, Chang & Chrisman, 2013) suggests that family influence and control and intra-family transgenerational succession intentions are negatively related to the propensity to use incentives because family members are eager to preserve economic and non-economic wealth benefits within the family for generations. Therefore, it is of outmost importance that family firms understand the trade-offs between the achievement of economic and non-economic goals in determining whether to offer incentive compensation to non-family managers.

Particular attention has to be given to non-family CEO compensation. Recognising the implications of CEO compensation, Gomez-Mejia, Larraza-Kintana, and Makri (2003), focusing on a sample of publicly traded family firms, found that family-member CEOs earn less total compensation than non-family CEOs. They explained that family-member CEOs do not need compensation that follows external market trends because their family ties make them less likely to exit the firm to pursue other career opportunities. In essence, family-member CEOs are less disposed to leave and are willing to receive less compensation in exchange for the additional job security and the socio-emotional benefits that family involvement provides. More recently, other scholars showed that objective performance-based measures play a significant role in CEO compensation, especially when outside CEOs are at the helm (Michiels, Voordeckers, Lybaert, & Steijvers, 2012). In other words, when a non-family CEO is at the top, clear, objective and tangible performance incentives should be planned.

c) Arrangements which allow external managers to contribute to business profitability

Once the decision is made and recruiting is accomplished, the daily working process starts. In order to allow non-family professionals to be successful contributors to the business activity, the family must clearly communicate those values which, in their view, need to be upheld and

should focus on articulating ends rather than means. In other words, the family should outline the ultimate goals they would like to achieve, while allowing the professional manager some discretion to implement new ideas and methods to achieve these goals. This is extremely important because it is highly likely that family members and professionals have a different approach in problem analysis and in relating to others.

Besides offering compensations plans to key professional managers for them to “think like owners” and not to focus on parochial management interests, there could be other options. For instance, including key professional managers in the board of directors. This might prove to be a good way to gain their input as well as to teach them how the family feels about the business. Building family/non-family management teams which provide complementary skills at the top and set benchmarks for running the family business professionally would be a further alternative.

Transparency is extremely critical to the motivations of higher professional managers. Good practices which should be activated in growing family businesses include discussing with transparency issues such as career advancement opportunities for non-family managers, how the succession process may affect these opportunities, involving them in business and succession planning, organising periodical meetings to promote mutual understanding and respect for the different roles and contributions, or surveying them periodically to assess the work climate (Poza, 2010). Communication between family members and outsiders will also help to educate the entire family, whether active or inactive in the company, about business and management in order to create common ground between family and non-family managers.

Moreover, encouraging professional managers to become a part of the community is extremely important. When professionals live outside the community, communication barriers are often created between professional managers and local employees, and an “us versus them” mentality is created. Some family and non-family members may feel their career goals and sense of self-worth threatened if outsiders begin to occupy key management positions. This can intensify feelings of suspicion and distrust and eventually lower the overall organizational effectiveness (Dyer, 1989).

In short, the conclusion can be drawn that professionalisation is certainly not one-dimensional. For example, hiring salaried managers, absent other changes, is a failing strategy (Sukumar, 2011; Ward, 2004). Professionalising can therefore involve a holistic change, albeit one varying somewhat from firm to firm (Hung & Whittington, 2011; Parada

et al., 2010). People should be placed in positions and rewarded based on merit. Implementing this principle in firms where it had been lacking often requires a shift across several managerial dimensions. It could also entail new systems and organizational designs to monitor and reward managerial performance. Moreover, it should be taken into consideration that, especially in these firms where emotions play a central role, merit does not presuppose that the goals to be “achieved” must purely be economic (Stewart and Hitt, 2012).

Board Structure and Functioning: Bringing Value to the Business

The board of directors is a legally recognised structure having powers and responsibilities for the company as a legal entity, usually prescribed in the articles of incorporation or equivalent legislative instrument. It is the decision making body chosen by shareholders to control a company, appoint senior officers and decide on its policies. This status gives the board unique rights and responsibilities, which expose directors to a larger sphere of liability, which may require the company to provide directors with liability insurance. Outsiders or younger members may fear this liability. For this and other reasons, many family-owned businesses prefer to restrict membership on the board of directors to selected family members and use an advisory board as a complement to the board of directors. The advisory board does not reduce the legal liability for directors, still it offers the board new perspectives and experience. This should avoid wrong decisions supported by a myopic view of the business and the outside world, which can easily be developed within a family.

Boards may have different roles according to different contingencies such as the size of the company and the nature of the relationships among family members. Obligatory boards of directors typically emphasise their responsibility to monitor or provide oversight to management. The emphasis on monitoring is reflected on most boards in the publicly traded and management-controlled universe of companies and some of the larger family-controlled but publicly traded companies. When it comes to small to mid-sized family firms, especially if they are privately held, board of directors are more likely to emphasise an advisory and value-adding responsibility. Differently from the board of directors, discretionary advisory boards have a primary mission to advise and counsel – not to monitor – especially when family unity exists and interests within the family and among family and outside members are aligned. On the contrary, when family conflict exists or when different priorities start to emerge, these boards are less capable

of exerting the needed monitoring function, because they do not have the statutory power to oversee the business governance and managerial activities of the company (Westphal, 1999).

Especially when making the transition to a more sophisticated organizational structure, the challenge is to preserve the company's culture and history while adding fresh expertise and insight. As the business grows, longest-tenured board members may not have the expertise to guide the decision making process successfully. Using an advisory board to keep them on while using the advisory board to add outsiders perspectives, can be a valuable strategy.

In general, the advisory board is often considered a "compromise solution" between a family dominated and a more independent board. Many family businesses recognise the need for an independent board, but are also uncomfortable sharing sensitive company information and decision-making power with a group of outsiders. These family businesses often opt for the creation of advisory boards as a way of getting outside advice and expertise while keeping control over the company's real board. Gradually over time and once the family sees the added value of the advisory board and has more confidence in sharing sensitive company information with advisors, some of them are usually invited to join the board of directors.

a) The accurate choice of independent board members

Including outside members on the board of directors or/and on the advisory board may represent a very healthy development of many family-owned businesses. Here a question arises: how many independent board members should be included? Traditional research indicates that board size should be limited to five to nine members in order to function well (Nash, 1988). Ideally, private firms which are still under full ownership of the family should have two to three independent directors; having just a single outsider is too isolating for that one director and a minimum of two is needed to truly affect board dynamics (Poza, 2010). For public companies – whether still majority family-controlled or with the family being a large but minority shareholder – independent directors should form the majority of the board in order to represent the full range of interests. There are nuances to this formula. In companies with one large or single super-voting shareholder, it is less important to have independent voices on the board. Should a company, on the contrary, have a much more diffuse and geographically dispersed group of family owners, a plurality (vs. a majority) of independent directors allows for enough unbiased perspective to come through (Bettinelli, 2009).

Indeed, this decision must be taken according to state policies and laws and corporate governance practice is complexly embedded in cultural, legal and political settings. Corporate governance regulation have increasingly been focused on the role of independent members on corporate boards (Hermes, Postma, & Zivkov, 2006). Codes of best practice are often based on the assumption that independent boards are vital for ensuring sound financial reporting and preventing fraud (Higgs, 2003). Also, almost all rating systems pay attention to board independence (Van den Berghe & Levrau, 2004). The concept of “board independence” was a cornerstone in the influential Cadbury Report (1992) in the UK and it now occupies a central position in the corporate governance codes of European countries (Hermes et al., 2006). In the US, the corporate scandals of the early 2000s (e.g., Enron, WorldCom) fortified the perceived importance of independent boards. Both the New York Stock Exchange and NASDAQ, in their listing standards, now require listed companies to have a majority of independent directors. Even when these codes do not directly apply to privately held family businesses, there is evidence that various stakeholders, such as banks, investors and suppliers, require higher financial transparency, timeliness, accuracy and internal controls (Poza, 2010).

Overall, even if research is far from being conclusive on the link between the inclusion of independent outsiders on the governing board and firm financial performance, most scholars agree that a good balance between insiders and outsiders’ interests is needed (Klein & Bell, 2007). Without independent directors, large family shareholders seem more prone to engage in self-dealing which benefits them over minority shareholders. Having independent directors may provide unbiased objective views, bring a valuable network of contacts and a fresher and broader perspective to issues of concern to the firm and the family. The board is also in the unique position of being able to enhance the perceived quality and fairness of the succession decision.

The issue of the value of independence is extremely critical, not only for auditors who certify financial statements, but also to guarantee meaningful long-lasting contributions to the business. First, consultants and other professional service providers do offer benefits to the organization, but their commitment is usually oriented to specific goals, which limits the possibility of a long-term relationship with the company. Furthermore, their being paid for single projects compromises their ability to disagree respectfully as well as their independent thinking which characterise valuable outside board members. Second, ideal independent outsiders should not be chosen

among friends and family, to avoid the risk of rubber-stamp boards. The majority of these members should be, for instance, professors from Business Schools, professional service providers who derive no revenues from their relationship with the company besides the board service fee, successful managers of other companies who do not have any conflict of interest, etc. Participating in the industry and community life, meeting new people and networking are extremely important for family members to find the right people. Business seminars and university programmes can be very helpful as well (Poza, 2010).

b) Ways to insure a well-functioning board with independent directors

Truly independent directors will challenge the family thinking and add more discipline to the board meetings. Furthermore, the presence of independent directors during board meetings will discourage family members from wasting valuable time on family issues and concentrate on the business strategy and oversight instead. Moreover, independent directors can also play the “buffer” role among different family members in case these have contradictory views on business issues.

In short, it can be argued that independent directors take on the role of sages when it comes to company strategy setting. Being wise, however, does not necessarily imply to be conservative. To make sure that the board is always rich of fresh perspectives, board members should be nominated for 3 to 5 years. Only those people who are able to reinvent themselves by continuing to contribute from the intimate knowledge of the company can be retained beyond the specific deadline.

Another issue which is wise to pay attention to is the composition of the board: finding complementary skills, experiences and capabilities can be an extremely fruitful resource base for the company.

Compensation needs to be attractive and in line with the marketplace, but the continued motivation of board members is more important than compensation: their ideas need to be listened to, they need to feel that their contributions make a difference and that they share responsibilities. One sentence which perfectly summarises this concept is “outside board members need to share the CEO’s dreams”. The family needs to take a step back and let them see the company’s financial records and get personally acquainted with the shareholders and the members of the next generation. This is the only way to ensure that they have all the information useful to help the company plan for the future (Poza, 2010).

Establishing a strong and independent board is a clever decision which most families in business take once their company’s operations reach a

critical size and complexity. Actually, however, when it comes to board membership, most family businesses reserve this right to members of the family and in few cases to some well trusted non-family managers. This practice is generally used as a way of keeping the family control over the direction of its business. Unfortunately, the absence of outside independent directors might make it difficult for a family business board to gain the missing knowledge and expertise (International Finance Corporation, 2008).

Family Governance Institutions:

The Role of Family Meetings, Assemblies and Councils

Family governance practices and institutions require a certain degree of formalisation to function well. As families adopt policies on the family approach to the business and on governing the business, they will structure these efforts with documents which will differ depending on their ownership stage. Typically, in the earlier stages when the company is governed by founders or their children, many aspects of family and business governance are informal. Any efforts to formalise relate mostly to the business itself. Usually, written policies such as brief documents stating a general family vision and mission with respect to the company are the first attempts to think about possible configurations of the organization.

The next level of formalisation comes with the need to develop a family employment policy. This becomes more apparent when the company reaches the “sibling partnership stage”. The family employment policy sets clear rules on terms and conditions of family employment within the firm. For some families, these rules stipulate conditions of entry, retention and exit from the business. The policy should also cover the treatment of both family members and non-family employees. In third and succeeding generations, family firms can barely survive unless full family governance policies are written and communicated within the family and the business, as well as to other outside stakeholders. The document covering all of these policies is commonly called a family constitution. This document expresses the family principles regarding the family commitment to core values, vision and mission of the business. It often defines the roles, compositions and functions of family governance institutions and the company governance bodies, such as the shareholders’ meeting, the board of directors and senior management.

One of the most critical practices in this developmental process is the establishment of a more or less regular meeting agenda among family

members. Allowing them to gather under one or more organised structures strengthens communication links between the family and its business. This approach also provides opportunities for family members to network and discuss issues related to the business and the family. Especially once the “cousins’ confederation stage” is reached or when the company opts for renewal, creating the family office and the family council is a good governance practice. This action establishes practices which generate greater transparency and the trust of outsiders (International Finance Corporation, 2008).

Family councils have the primary goal to keep the traditional familiar values alive, resolve and avoid family conflicts as well as support the education of family members about company’s issues. They often deal with issues of liquidity, diversification of the estate and estate planning. Usually, they do not vote on issues, while they develop policies to guide decisions made by other governance bodies, such as the board of directors. When families are very large, a family assembly – which includes the larger family – sometimes operates in conjunction with the smaller family council. Another body which can be found in family firms run by the second or subsequent generations is the family office. Services offered are different depending on the needs of each firm. In general their responsibilities include the responsibility for joint family investments, family philanthropy, tax and legal advice to shareholders, the filling of required legal documents on behalf of the shareholders, the planning of family assemblies, etc. (Poza 2010).

Families in business need to nurture members’ feelings of trust and pride concerning the family and business as well as build a sense of teamwork to keep a family committed and disciplined in its relationship to the business. It is wise, therefore, in the family council and family assembly to emphasise consensus decisions around family goals and policies, openness to various viewpoints, as well as significant transparency in company operations, decision making and ownership holdings.

The Real Goal of Family Businesses: The Right Governance Practices at the Right Time

One main feature of family firms is the multiple roles that family members play within the family and the firm. This role-diversity combined with the entanglement of ownership and control affects the corporate governance structures and leads to distinct and specific requirements compared with their non-family counterparts. Besides the supervision and control of

management, family businesses need to establish governance structures which enhance cohesion and shared visions within the family, while at the same time reducing harmful conflicts. Correspondingly, the consideration of the family dimension (i.e. family governance) is an integral part of the governance structure of family firms.

Firm growth has necessarily to be accompanied by a development in the organizational governance practices to guarantee firm survival and prosperity. Families have to overcome frictions that prevent them to take decisions which might appear to be quite revolutionary according to the traditionally shared mentality.

In this chapter, practices were suggested which regard the business, the family and the ownership systems. First, families should consider including business outside professionals who can bring useful knowledge and skills to the business. Some planning is needed in order to find the right people and arrange all the conditions for them to be able to provide their valuable talent to the business. Second, independent board members might be included in the board of directors. Successful companies are those which have an effective board of director who execute their responsibility of shareholder's wealth maximisation with effort and dedication. However while in most well managed companies such directors are seen as resources bringing with them external know how, in some companies especially family owned and managed businesses they might be considered a burden enforced by statutory regulations. If this is the case, advisory boards can be a good compromise solution. In all these cases, the first hurdle is the decision to bring in outside people, to share sensitive information and to listen to possibly uncomfortable input in front of a group of people. Once that hurdle is cleared, the road to success with external board members is well-marked. Family business owners who go down that road will find a new source of energy, ideas and experience open to them and to their firm preserving those traditional values which made firm growth possible.

Finally, as a firm grows also the family needs some level of structure. The larger and more extended nature of the family then necessitates a more formal approach than that used in the past, when casual family meetings preceded the existence of a family assembly or family council. These governance bodies are useful to interact and bond with one another particularly if the family is large and dispersed to discuss and share information and opinions on business developments and to educate family members about their rights and responsibilities towards the family business.

In general, families need to remember that what is extremely important, especially during firm developmental periods, is a good coordination among all governance practices. Yet, good structures which do not address the right topics are a costly waste of time. Therefore, planning the future becomes extremely critical in these contexts. Good communication between family and business governance structures is essential to business success and family peace.

Discussion Questions:

1. Which are the main differences between conventional business governance and practices of family business governance, and how do they influence governance effectiveness?
2. Professionalising is considered to be a necessary step in the transition from controlling owner stage to the cousin consortium stage: explain the reasons why this statement is true.
3. Family firms manage the professionalisation process following three different ways: by bringing outside professionals in the company, by professionalising members of the owning family, and by training non-family employees working in the business. Highlight the pros and the cons of each option.
4. Which are the contingencies affecting the roles played by the boards? How do they impact the board structure?
5. Family meetings or family councils? Explain which are the primary goals of these governance practices.

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Chapter 22

SME Financing: Considerations for Boards and Management

Morina D. Rennie

Abstract

A critical aspect of the governance process of small and medium sized enterprises is managing the company's relationship with its lenders. Loans from financial institutions is the most important source of financing for SMEs (Ang, 1991, Philbrick, 2004, Behr & Güttler, 2007, Berger et al., 2001), making lenders important stakeholders. SMEs face a number of challenges when it comes to dealing with lenders. It is therefore important for those charged with governance to understand these challenges and be aware of how they can be met.

This chapter looks at the difficulties inherent in the relationships between small and medium sized enterprises and their lenders together with research that has shed some light on this relationship.

Introduction

Obtaining capital is critical to the success of SMEs, and managers and directors must make sure they understand the challenges associated with this process and take steps to ensure that they are able to effectively manage these challenges. The financing landscape for small and medium sized enterprises is significantly different than it is for large companies, SMEs having differing and more limited sources of financing. In general, SMEs do not have as much access to external funds as larger companies (Hall, Hutchinson, & Michaelas, 2000). They often rely heavily on debt financing. Senior debt is the primary form of financing in part because owners do not want to give up equity in their company and junior secured lenders do not often serve the SME segment of the market (Philbrick, 2004).

An asset-based structure (that is, when assets serve as collateral for a loan) is a typical type of financing for a small business (Philbrick, 2004). The Canadian Financial Executive Research Foundation (2011, p. 12) describes some of the difficulties associated with this form of financing for SMEs:

Long-term lending, which is so inexorably tied to collateralized assets and the ability to provide a solid set of financial statements as leverage for loan consideration, has, even in the best of times, remained a challenge for many businesses. In periods of recession, the ability to articulate future viability is particularly difficult for small public companies.

Hall, Hutchinson, and Michaelas (2000) carried out a study of the capital structure of private SMEs. For the 3,500 firms in this study, it was found that on average, there was greater use of short-term debt than long-term debt. However, the proportionate use of these two forms of debt financing varied significantly by industry. Interestingly, they found that profitability was negatively associated with the proportion of short term debt utilized, but was not associated with the proportionate use of long term debt.

It has been found in various studies that SMEs pay higher interest rates than larger companies (for example, see Pagano, Paneeta and Zingales, 1998 and Sinkey, 1998). This is explained in part by obstacles lenders face in finding information about SMEs, including the difficulty of obtaining audited financial statements. Heffernan (2006) used an econometric model to study the pricing behaviour of UK financial institutions and concluded that SMEs would benefit from public policy measures to create more competition in the banking industry.

A challenge for SMEs seeking financing is that their businesses are often based on one product line or a single customer base and this makes them more cyclical than larger companies (Philbrick, 2005, p. 52). Another difficulty is the disconnect between the risk aversion of banks and the risk seeking approach of many SMEs and that it may not be in an SME's best interest to take on the conservative approach that their lenders would like (Story, 2002). Allard (2011) observes that SMEs took longer to recover from the 2008 financial crisis because they had more difficulty than larger firms getting access to financing – capital providers imposed tougher hurdles for obtaining credit and higher costs on smaller companies.

In the next section, the primary causes of SME financing challenges are explored.

Barriers to Borrowing: Agency Problems and Information Opacity

“A distinctive feature of the private debt markets that finance small businesses is that they are plagued by information and agency problems that arise from the informational opacity that is typical of these firms” (Ortiz-Molina & Penas, 2008, p. 362).

In their seminal article that articulates an agency-based theory of the firm, Jensen and Meckling (1976) model the lender-manager association as an agency relationship with the lender as principal and management as agent. They describe an agency relationship as “a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent” (p. 308). Agency problems arise because lenders cannot directly observe the actions of management who may not always act in the best interests of the lenders. For example, there is a risk that management may take actions that increase the likelihood that the company could fail to meet its interest and principal payment obligations or even go bankrupt. Monitoring and bonding mechanisms, such as debt covenants and provisions in lending agreements that require the company to regularly provide audited financial statements to the lending institution, have evolved to help mitigate risks for lenders.

Ang (1991) observes that consideration of the unique attributes of SMEs expands the topic of agency beyond the generic scenario modelled by Jensen and Meckling: “The absence of publicly traded shares, the risk taking tendency of entrepreneurs, the lack of management depth, the problem of succession, and the limited personal wealth of owners could imply a shortened expected duration for the firm and thus a shortened transaction horizon with the stakeholders as well, which in turn creates opportunities for agency problems” (p. 4). It is generally more costly to resolve agency problems in the context of SMEs; for example, SMEs experience relatively larger bonding and monitoring costs as compared to other companies which affects the overall costs of obtaining financing (Ang, 1991).

A significant related problem specific to the SME-lender relationship is information opacity. It is simply more difficult to get a full understanding of the risks and potential of an SME than it is for a large public company; investors need firm-specific information that helps them distinguish between high profit/low risk firms and low profit/high risk firms and this type of information on small firms is costly to obtain (Brewer, E., 2007, p. 42). Berger and Udell (2007) describe the problem from the perspective of SMEs:

Nonetheless, small firms have historically faced significant difficulties in accessing funding for creditworthy (that is, positive net present value) projects due to lack of credible information about them by potential providers of funds. Small businesses are typically much more informationally opaque than large corporations because

they often do not have certified audited financial statements to yield credible financial information on a regular basis. Also these firms usually do not have publicly traded equity or debt, yielding no market prices or public ratings that might suggest their quality. (p. 5)

Craig, Jackson, and Thomson (2007), add two more information-related issues that can lead to financing problems for SMEs: (1) many SMEs are fairly young and may have little credit history and (2) lenders may have difficulty evaluating the risk of new or innovative products and so may be reluctant to provide funding (p. 117).

Ang (1991) points to information asymmetry (insiders having more information about the company than outsiders) as a further problem. He argues that information asymmetry is greater in SMEs for four reasons: higher fixed cost of obtaining information for small transactions; fewer repeated transactions; smaller incentives for outside analysts or rating agencies to gather information on SMEs; and greater difficulties for SMEs in signalling their quality to potential lenders (Ang, 1991).

The information problem inherent in the SME-lender relationship could potentially cause credit to be denied to those that could have used those resources profitably. It is incumbent on SMEs to manage this situation to ensure that their companies get the financing they need. Lenders and SMEs have devised a number of different approaches to overcome agency and information problems associated with SMEs and some of these potential solutions are discussed in the next section.

Approaches to Overcoming Borrowing Challenges

Several approaches to the lender-SME relationship can help both parties resolve some of the difficulties arising from agency and informational opacity problems.

Audited Financial Statements

One thing that an SME board or management may consider is having the company's annual financial statements audited, even though an audit can be costly. Audited financial statements reduce opacity and also mitigate agency problems by allowing lenders to monitor the progress of the company. Dharan (1992) argues that by volunteering to submit audited financial statements, an SME can signal to lenders that it is a low-risk company. However, in many cases, companies may not have a choice about submitting audited financial statements – lenders may require them as a condition of obtaining a loan. Martin, Handorf, and Clewell (1988) found that commercial loan officers were most likely to

require audited financial statements for larger loans. They also found that the more highly leveraged the company, the more likely it was that an audit would be required.

There has been some evidence that providing audited financial statements can result in lower interest costs. Blackwell, Noland, and Winters (1998), in a study of revolving credit agreements involving private American companies, found lower interest rates were paid (on average) by companies that had obtained an audit. In a study of Finnish private companies, Karjalainen (2011) found that a lower interest rate was enjoyed by those companies having an audit by a Big 4 firm or by multiple auditors (note that the Big 4 are the world's top four accounting firms). They also found that a clean audit report and higher accruals quality was associated with lower interest rates. On the other hand, Fortin and Pittman (2007) looked at 144A bonds issued by private American firms and did not find an interest rate impact or a credit rating impact from choosing a Big 4 auditor.

Relationship Lending

Another way to deal with information opacity and agency problems is for SMEs and lenders to enter into long term relationships. Such a relationship allows the lender to gain an understanding of the SME so as to fully assess risk and allows the SME to demonstrate trustworthiness. Another benefit is that in a relationship-lending scenario, banks may consider profit with respect to the entire relationship with a company over time rather than on a transaction by transaction basis (Steijvers, Voordeckers & Vanhoof, 2010). Such a strategy is more common in some countries than others. For example, in Germany, where debt is the primary form of financing, bank lending usually occurs within close, long-term relationships between financial institutions and their clients (Behr and Güttler, 2007).

In a study of Argentinean SMEs, Berger, Klapper, and Udell (2001), found that smaller companies were more likely to have exclusive relationships with their lenders, other things being equal. They also found that foreign banks and large banks were less likely than other banks to become involved with relationship loans to SMEs. Brewer (2007) observes that “an important point that comes out of the relationship-based lending literature is that once an informed bank manager has screened the pool of available borrowers, he knows firms’ credit quality and can charge them an interest rate that reflects that quality” (p. 44).

Collateral and/or Personal Commitments

Another option is for an SME or its owners to bear some of the risk by putting up collateral or by making a personal commitment. Steijvers,

Voordeckers and Vanhoof (2010) observe that “the benefits generated by collateral pledging include the reduction of agency costs, limitation of possible legal claims, reducing informational asymmetries and refraining from excessive future borrowing” (p. 245). While the cost of pledging collateral can be high, it does provide an additional incentive for companies to act in good faith and could lead to reduced borrowing costs (Steijvers et al., 2010). However, it should be noted that in many cases, lenders may require collateral as a condition of obtaining the loan.

Ang, Lin, and Tyler (1995), in a study of small American firms, found that in the absence of available business collateral, a large proportion of small business owners had to pledge personal commitments – either by personally guaranteeing the loan or by pledging personal assets in order to obtain business loans. They observe that requirements like personal commitments mean that risk of business failure may include personal ruin and that theoretical corporate finance theory models generally do not take this into account (Ang et al., 1995).

Steijvers, et al. (2010), in a study of small American firms found that family firms were more likely to pledge collateral and pledge personal commitments for their loans than other companies. This was particularly true in cases where the firm wanted to borrow a large sum and had relatively few assets that could be offered as security for the loan. In another study, Voordeckers and Steijvers (2006) examined credit approvals issued by a large Belgian bank relating to SME loans. They found that characteristics of the borrower and characteristics of the lender-borrower relationship were the most important determinants of whether loans were placed into a category that provides the bank with little protection (secured debt) versus medium protection (secured debt with only business collateral) versus high protection (secured debt with personal commitments).

Other approaches:

Research has also looked at other ways SMEs could overcome agency and information problems. For example, SME boards and/or management could consider seeking short term loans rather than long term loans. Ortiz-Molina and Penas (2008), in a study of small businesses, found that informational opacity was associated with shorter loans. They also found evidence supporting the idea that collateral pledging is associated with longer loan maturities and pledging personal collateral is associated with even longer loan maturities – suggesting that collateral and maturity could be substitute approaches to mitigating agency problems.

They did not find any evidence that the strength of the lender-borrower relationship was associated with loan duration.

Another approach to mitigating the information opacity problem is the use of small business credit scoring which involves using a statistical approach to predicting a firm's future credit performance. Berger and Frame (2007) report that, in a survey of American banks, the majority said that they used small business credit scoring (SBCS). This tool was predominantly used for loans less than \$250,000. The authors observe that SBCS has not only increased the ability of opaque, risky borrowers, those from lower-income areas, and those from farther afield to obtain loans, but has also increased loan duration and amount of credit provided overall (Berger and Frame, 2007).

There have also been public policy initiatives to increase the availability of credit to SMEs. For example, Craig, Jackson and Thomson (2007) report on the American Small Business Administration (SBA) loan guarantee program. In a study of SBA loans, they found a significant positive relationship between relative levels of SBA loans and per capita income growth in local markets. This evidence appears to support the public policy value of making these loans available to small businesses.

Conclusion

The ability for boards and management of SMEs to effectively navigate the challenges of obtaining debt financing is critical to the success of the business and the economy. Informational opacity and problems in the SME-lender agency relationship can be overcome – but the board and management team must be aware of the options that are available and must discern which of these alternatives is the most well suited to the situation at hand.

Discussion Questions:

1. How do SMEs and larger firms differ with respect to sources of financing and what particular disadvantages may SMEs have as compared to larger firms when securing financing?
2. What challenges does the SME-lender relationship present?
3. What is information opacity and what barriers does it create for SMEs who wish to obtain financing?
4. What options do directors and senior management of SMEs have to overcome the challenges of obtaining financing?

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BIOGRAPHY



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Chapter 23

Corporate Governance in Malaysia – Cosiness, Cronyism and Corruption

Allan Chang

Abstract

This chapter highlights the prevalence of political interference in large government-linked companies in Malaysia that distorted the concept of corporate governance. Three large Malaysian companies were chosen in this study, namely, Perwaja Steel Ltd, Renong Ltd and Malaysian Airlines Ltd. These cases illustrated how these Malay-controlled companies could circumvent legislations in the country and ignored the rights of minority shareholders. It also illustrated that company laws are poorly enforced in Malaysia and politically-connected companies are able to operate above the law. The close relationship between businesses and politics resulted in a cozy arrangement that fosters corrupt practices that enriched certain politically-connected individuals and the top politicians. Under a New Economic Policy introduced in 1970, public funds in Malaysia are diverted to enrich certain Malay businesses. Such abuses of power are so rampant that corporate governance in these companies is non-existent. The CEO makes all decisions in these companies, guided by the whims and fancies of their political masters. Consequently, it was rare for any of these CEOs to be prosecuted for breaking the country's laws.

Introduction

In Malaysia, it can be seen that the state intervention in the economy began in 1970 when the government initiated the positive discrimination policy, i.e. the New Economic Policy (NEP). The affirmative policy was introduced to achieve national integration through poverty elimination and society restructuring to eliminate economic imbalances due to ethnicity. Under the NEP, government tried to promote Malay and indigenous entrepreneur groups in the economic sector. The government tried to achieve a target of 30% Malay ownership of the corporate sector. Among the first to be targeted to increase Malay participation in the commercial

sector was public enterprise. However, this method had resulted in the introduction of a cozy relationship between business and politics.

Initially, the government merely acted as the shareholder for the Malays, but it eventually became owners of companies and investment proxies through companies owned by the ruling political parties. Various methods were devised to implement these affirmative policies. The most effective method was privatizing state owned telecoms, energy and airline companies. These companies were listed by the government on the stock exchange with Malays as the controlling shareholders. In addition, the country three largest banks in Malaysia came into the control of the Malays through the active efforts of the government in buying bank shares from the Malaysians of Chinese origin and selling them at discounted prices to the Malays. Another method involved the use of public funds to form state economic development corporations (so-called SEDCs) in each of Malaysia's 13 states in the federation. SEDCs role is to form private companies to start various types of businesses, usually involving large capital injections and given monopoly rights to manufacture products such as cement, silk and industrial cables. Most of these state enterprises are not viable businesses and had to be closed down after operating a number of years, resulting in huge losses to the state. Those few enterprises that actually succeed are transferred to the Malays who are politically connected to the state (cronies) or relatives of the ruling party (nepotism).

According to the government, the NEP had not achieved its intended target of 30% Malay ownership of the corporate sector. In 1970, when the NEP began, the Malay's share of the corporate sector was 19%, and in year 2000, after 30 years of implementing the policy, the government announced that the Malay's current share is the same at 18.9%. It brought howls of protest from the other races in the country (mostly ethnic Chinese and Indian) who saw it as an attempt by the government to manipulate these figures in order to legitimize the continuation of the policy of giving 'handouts' to the Malays. No one believed the figure but sadly, no one dared challenging it for fear of a backlash from the government, which includes using the draconian 'Internal Security Act' to imprison anyone without trial indefinitely.

The NEP was designed to benefit all Malays but in reality, only a select group of politically connected Malays were given the opportunities to own these large enterprises and therefore benefited immensely from it. These selected Malays operated above the law and were never prosecuted when the rights of minority shareholders were infringed or company funds were

mis-appropriated. This is shown in the three cases selected for this paper.

Before examining these case studies, however, it is useful to understand the legal framework affecting companies in Malaysia. The Malaysian legal framework, like the Anglo-Saxon model upon which it is based, is rather comprehensive. There are rules on related party transactions to protect the interests of minority shareholders from expropriation or abuses by an insider, including the controlling shareholder. Shareholders appear to have more powers to limit the discretion of insiders in key corporate matters in Malaysia than elsewhere in Asia. In Malaysia, there have been legislative measures to increase the number of matters that require the general meeting's approval (Thillainathan, 1998). There are also legal provisions to prevent abusive behaviour by insiders, namely stiff penalties against insider trading, a take-over code to protect against violation of minority shareholders rights and shareholders are entitled to full pre-emptive rights on new stock issues, unless they have voted to do otherwise. Minority shareholders in Malaysia do enjoy some protection from abuses of insiders from existing laws and regulations.

The Malaysian code of corporate governance was introduced in year 2000 after the country was devastated by the financial crisis of 1997/98. It appeared good on paper with plenty of good corporate governance practices in place to ensure companies become good corporate citizens. Sadly, the only drawback is that the code is not mandatory to follow. Compliance with the code is purely voluntary and companies need only to disclose why they had deviated from the code.

Three companies are selected as case studies to illustrate the state of corporate governance in Malaysia. They are Perwaja Steel Ltd, Renong Ltd and Malaysian Airlines Ltd (MAS). The chapter illustrates the bizarre manner in which these companies operate, demonstrates how politicians colluded with businessman to divert public funds to enrich themselves.

Perwaja was established in 1982 by HICOM Ltd., a company owned by the government in collaboration with a Japanese company, Nippon Steel Corporation to fulfill the government's mission in spear-heading the heavy industries in the country. This is an example where the government had direct interest, as shareholders in a company.

Since incorporation and until recently, Perwaja Ltd not only failed to gain any profit but was involved in endless scandals and corruption. In 1986, Perwaja reported a loss exceeding RM131 million, due principally to internal management problems and currencies movements of the Japanese Yen which appreciated against the Malaysian ringgit (RM). Within six years

of commencing operations, the company was on the brink of bankruptcy. Perwaja suffered huge losses of RM2.95 billion and at the same time owed creditor banks another RM7 billion. Perwaja was also facing allegations of corruption and mismanagement in the award of tenders and contracts. As an example, Mah Sun Company and its related companies were awarded with RM967 million worth of contracts without any authorization from the board of directors. These contracts were awarded by the company's managing director (Eric Chia) and he is a political appointee of the Prime Minister, Dr. Mahathir. It was suspected that Eric Chia was directed by his political masters to award the lucrative contracts to certain political cronies. Corporate governance in Perwaja was and still is constantly subjected to interference from top politicians. Another RM103 million worth of contract were also awarded to the same company without any documentation. Furthermore, dubious trading transactions and payments were carried out to non-existing company, i.e. Frilsham Enterprise (Nor Azizah, 2004).

In 1990, Datuk Seri Anwar Ibrahim (Minister of Finance at that time) informed Parliament that Perwaja was insolvent. However, no legal actions were taken against Perwaja until Eric Chia, the managing director of the company was arrested in March 2004. Today, Perwaja is still in operation with fresh funds of RM2 billions being injected by the government (Netto, 2004).

On the other hand, Renong Ltd was known as United Malays National Organization (UMNO)'s investment arm in the corporate sector. UMNO is the dominant political party of the ruling government. The involvement of UMNO started when Renong (after being taken over by Halim Saat) bought all Fleet Group assets from Fleet Holding (UMNO's investment company) via a reverse takeover with an issue of RM1.226 billion shares (Yong et al., 1991). Halim Saat admitted that he is an UMNO proxy in the business (Gomez, 1994).

Renong became a successful conglomerate after Halim Saat (finance minister Daim's protégé) took over its management. Halim bought Renong's shares via UEM, while PLUS issued RM17 billion of bonds at coupon rate of not less than 10% per annum, in order to settle Renong's debt amounting to RM8 billion in seven years (Jayasankaran, 2003).

Halim Saat was also the director in several governments owned companies, i.e. Landmark Holdings and Paremba. He was also the director for several listed public companies where Daim's (the Minister of Finance at the time) family members were among the shareholders, i.e. Roxy, D&C Bank and Clod Storage (Gomez, 1990). Halim has spurred UMNO's move

into business (Yong et al., 1991). Renong was richly rewarded with various infrastructure development contracts by the state (Gomez & Jomo, 1999).

The case of Renong Corporation has revealed the sad state of corporate governance in Malaysia. The Asian Financial Crisis of 1997/98 (which led to the steep devaluation of the Malaysian ringgit) caused serious financial problem for Renong. Moreover, it had also increased the amount of Renong's accumulated debt, estimated as between RM20–28 billion. This constitutes more than 5% of total loans in the Malaysian banking systems (Gomez, 2002; Thomas, 2002). Many economists were dumfounded by its incredibly huge exposure. Many commentators were at a loss to explain how the company managed to obtain such a large amount in corporate loans. Did the board of directors and shareholders know that Renong had obtained such loans? Had the loan process and procedure been side-stepped? According to Gomez (2002), these figures indicated that a significant amount in bank loans had been channeled to a selected minority. During the crisis, Halim, who owned not more than 78% of the company's equity tried to save it via a restructuring process. He used his subsidiaries to pay Renong's debt and it had angered the minority shareholders as it was against their rights and interest. It was also contrary to corporate governance rules that require the shareholders be consulted and given the opportunity to vote on these proposals which affected them adversely. These rules are enshrined in the country's company laws but the directors who ignored the rules were never prosecuted. The government would not bring such infringement to the courts. Again, this sorry episode shows that company directors can break the country's laws if they are politically connected to the ruling party without any fear of prosecution. A large majority of analysts were of the view that this kind of funding was ridiculous, as subsidiaries fund should not be utilized to bail out its parent's debt.

In November 1997, Halim sold 32.6% of Renong shares to UEM at RM3.24 per share, 35% higher than cost price of RM2.40 per share (Ranawana, 2000). According to Gomez (2001), this acquisition was partly carried out through a RM800 million loan provided by government-owned (and politically well-connected banks), upset UEM minority shareholders. Later, PLUS, a Renong subsidiary, was used by Halim to fund Renong's debts (Nor Azizah, 2004).

Another similar case involved MAS, whose establishment and ownership are also related to the state. MAS started off as an airline company wholly owned by the government. It was later sold to Bank Negara (the nation's central bank) as a private entity. However, despite the full transfer of

ownership, the government still owned the “golden share” which entitles the government to have veto power on any decisions of the corporation deemed to be contrary to national interest (Lennane, 1997). In 1993, Bank Negara sold MAS to Naluri Ltd, a private company owned by Tajudin Ramli, another Daim’s protégé. The government still retains the veto power.

MAS was also plagued by internal management problems. Prior to the Asian Financial Crisis of 1997/98, MAS had already suffered losses due to the burden of huge debts accumulated by the new management under Tajudin Ramli. This had put MAS at risk during the crisis as all their transactions were done in US dollars. At the same time, Tajudin also had huge personal debts having obtained personal loans amounting to RM1.8 billion from four banks to enable him to buy a majority stake in MAS from Bank Negara’s (Jayasankaran, 1999).

MAS’s problem was compounded by the veto power of the government, which had stifled the company’s plan to expand or revise funding strategies for its debts. All decisions on airlines destinations were subjected to government’s endorsement. At the time, the destinations decided by the government were not popular destinations or less concentrated areas, but MAS had to oblige and extend its services to comply with Malaysian foreign policy as dictated by Dr. Mahathir, the country’s prime minister at that time. Such interference had resulted in lower returns for MAS compared to other airlines in the region. Consequently, the Asian Financial Crisis adversely impacted both MAS and Tajudin personally when debt levels rise significantly. Consequently, Naluri Ltd (Tajuddin controlled company that owned the aircrafts that were leased to MAS) sold nine of their aircrafts costing RM10 billion at an inflated price of RM14 billion to the government in order to settle Tajudin’s personal debts (MASSA, April 17, 1999). Such blatant use of public funds to bail out a Malay businessman shocked the nation.

Concluding Remarks

The state ownership in all the three companies and the manner it was divested are examples of the close relationship between business and politics. According to Gomez (1990), this cozy arrangement fosters a symbiotic relationship between business and politics, making them indispensable and dependable on each other. The Malay businessman relies on politician’s support to obtain government contracts. This essentially means that they are being enriched with resources owned by the government. On the other hand, politicians need businessmen

support to fund their political campaigns during the election season to enable them to be get re-elected as representatives in the government. This relationship can cause fraud in the system, leads to corruption and offer much freedom to businessman to act above the country's law (Noor Azizah & Halimah, 2007).

In all the above three cases, the directors in these companies broke many of the country's laws but there was not a single prosecution. Academics, economists and journalists had commented of the sorry state of corporate governance in the country but there has been little improvement. There is little appetite to implement the rules when politically connected Malays are involved. This had resulted in a very discerning investing public and leads to a lethargic and illiquid stock market that resembles a 'casino' rather than a respectable institution to invest.

The above case studies show that there was no governance system in place to check on the excesses of the CEO. In all the three cases, the CEOs are politically connected to the top politicians in the country. They do not operate under the normal rules and both CEOs and politicians benefited from the cosy arrangement. There was little consideration for the rights of the minority shareholders who had invested in these companies.

The f directors in these companies are politically appointed nominees and are retired civil servants, police or army chiefs and relatives of politicians. They were given these plum jobs as a reward for helping the ruling party in the general elections. They are not expected to play any governance role. In fact, these directors are powerless to curb the excesses of the CEOs.

The government's involvement in businesses has distorted the business structure in the country that resulted in two distinct types of businesses. The first type is the large government-linked companies, the second being small and medium-size companies which are efficiently run family businesses. They form the majority of businesses owned by Malaysians of Chinese and Indian origins. The financial performance of these large government-linked companies is generally poor. Even though these companies are badly managed, they had managed to keep afloat through the generous governments projects awarded to them.

These cases illustrate the gap between the legislative concepts of governance and the reality of the situation in Malaysia. There is a potential for further research into this issue that are common in Asia. The failure of Asian countries to implement their own legislations is a reflection of the problems faced by third world countries to remove a corrupt government. Ironically, despite blatant abuse of power, the ruling party remained in

power uninterrupted since Malaysia gained its independence from Britain in 1957.

The state's involvement in business has been significant and greatly increased its roles in many different ways. First, the state at its capacity as the shareholders had the right to be informed about the business operation and plan of the company. They can accept or reject any proposals of the company. It can also instruct the management of the company to pursue the goals of government. Second, the state as the owner of two of the largest financial institutions in the country controlled their management and the manner in which it provided funds and working capitals. Third, the state as a ruler, can instruct any agency and government offices to process applications for contracts, loan applications or tender from its wholly owned companies. The state, in the ruler's capacity is also the enforcer of rules and legislation gazetted by the government. This leads to a conflict of interest and consequently, misallocation of resources – essentially a situation known as crony capitalism where basic principles of corporate governance such as transparency, fairness and trustworthiness were ignored. The government's credibility as the ruler is brought into disrepute.

Discussion Questions:

- Q.1** Since the Asian Financial Crisis of 1997/98, the Malaysian government has been enacting various stringent rules to improve the state of corporate governance in the country. However, every research since the introduction of corporate governance rules points to the fact that enforcement is poor. The rules looks good on paper but without effective enforcement, it will not serve its purpose. Why is this so? Is this a common phenomenon in developing countries? How could enforcement be made more effective?
- Q.2** Malaysia has plenty of natural resources and blessed with oil, tin, rubber, timber and a hard working population for which welfare is unavailable. However, mismanagement and corruption has impeded the country's progress towards achieving an advanced economy such as her neighbor, Singapore.
- Will the government change with an electorate that's increasingly educated and intolerant towards abuses of power?
 - The ruling party had in the past stifled the opposition in Malaysia through the control of the press and giving no voice to the opposition parties in the media, either on television,

radio or the newspapers. But, with the advent of the internet, the opposition seems to have found a ready voice from a young populace hungry for independent reporting. Will this tilt the balance of power in the coming general election? Will the opposition be able to gain a greater share of the vote or form the next government?

- Q.3 The Malaysian government has blatantly use public funds to bail out political cronies but the ruling (UMNO) party gets elected to power at every general election since Malaysia gained its independence from Britain in 1957. Why is this so? Can democracy really work in a developing country? What are the alternatives? Is it possible for the opposition in Malaysia to rise and challenge the ruling party?
- Q.4 In 1990, Dr. Mahathir, the prime minister of Malaysia at the time announced that Malaysia aspires to be a developed country by year 2020. In 2013, twenty-three years later, the country is still under-developed and struggling with its identity as a nation. Increasingly, Malaysia is highly divided along racial lines and the Islamic religion is being aggressively promoted at the expense of the Christians, Buddhist, Hindus and others who are not muslims. Will the 2020 vision turn out to be an impossible dream? Can Malaysia catch up with her neighbor, Singapore who has now achieved developed status? What is lacking in Malaysia?
- Q.5 Malaysia and Singapore started at the same (under-developed) status way back in 1957 when Malaysia was formed and Singapore, then a province of Malaysia was kicked out of the Malaysian federation by the then prime minister, Tunku Abdul Rahman because Singapore's population compose of a large majority of ethnic hard working Chinese. Unlike Malaysia, Singapore is not endowed with any natural resources at all - ironically, she even have to buy fresh water from Malaysia. Why has Singapore managed to progress and surpassed Malaysia despite its lack of natural resources?

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BIOGRAPHY

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Chapter 24

Neither Arthur nor Martha: Reflecting on Governance Issues for State Owned Enterprises through the Lens of Solid Energy, New Zealand

Philippa Wells

Abstract

Solid Energy New Zealand (SENZ) is a state owned enterprise with all its shares owned by the Government on behalf of its shareholders, the taxpayers of New Zealand. The SOE model has been utilised in New Zealand since 1987 as a means of creating these companies as mirrors of private enterprise, with similar exposure to market forces and legislative expectations and requirements. However, it is inevitable that they be regarded and treated as different, not only by governments but also by other closely involved and more remote stakeholders. This chapter explores the situation and issues facing SENZ as an SOE and asks questions as to its likely future.

Introduction:

Solid Energy New Zealand Ltd (SENZ) (previously Coal Corporation of New Zealand) is a “natural resources company” (largely involved in coal mining in which industry it is the largest local player) that is 100% owned by the New Zealand government and subject to the State Owned Enterprises Act 1986. In accordance with the ethos behind this legislation, Solid Energy has a responsibility (under s4(1)) to be:

- (a) as profitable and efficient as comparable businesses that are not owned by the Crown; and
- (b) a good employer; and
- (c) an organization that exhibits a sense of social responsibility by having regard to the interests of the community in which it operates and by endeavouring to accommodate or encourage these when able to do so.

In early March 2013 (in a report to the Commerce Select Committee) SENZ reported a debt level of some \$390million, including borrowings of some\$295m and a predicted trading deficit (due to a softening international demand for coal) of around \$100m. This situation (a dramatic decline in

the fortunes of the company from the previous June) was described as “a matter of wide public concern”. Since then a variety of opinions, reports and media stories have variously blamed the recently resigned CEO Don Elder (for poor decisions and judgment but mainly for being the recipient of large and continuing remuneration, even when the company was failing and workers losing their jobs), Government (for refusing financial aid and support at the same time as pushing the company to increase debt levels and dividend payments) and the board (for failing to rein in the CEO and for poor strategic decisions).

The series of events and developments that have put SENZ in its present position have been described by Elder as the “perfect storm” (TVNZ, 2013) – a combination of negative market conditions and the high New Zealand dollar. However, they also raise questions around governance, not only in relation to the difficult financial situation for SENZ at this point but also around the relationships, accountability, objectives and future-proofing for a resource- focussed company like SENZ. This paper explores some of those questions. By way of background, the historical/contextual background to the creation of SENZ and its predecessor, Coal Corporation, is discussed. The second section addresses the establishment and more recent history of SENZ with a description of the structures and processes of governance as they apply to SENZ (as an SOE). This is followed by a brief description of two issues that have arisen since that establishment; issues that pose challenges as to its present and future accountability and focus. This section also highlights some of the difficulties that emerge in governance for SOEs, most particularly by reference to some of the main theoretical frameworks that have been mooted as a means of describing and evaluating corporate governance. The third section of the paper explores the specific governance-relevant questions that emerge from the issues identified above. The final section floats suggestions as to the likely or possible future for SENZ, a section that is followed by a more general conclusion.

Historical Background

The coal industry has long been an important part of the New Zealand economy with the first (limited) extraction of coal in around the 1830s. From 1874 the Governor of the colony of New Zealand was empowered to grant licenses for mining and to control the industry. By the 1890s, regions and districts were empowered to issue licenses and carry out their own regulation of activities in their geographical area. However,

and interestingly given the push to state involvement in energy-related industry from the 1860s onwards, coal mining remained dominated by private enterprise until the passage of the State Coal Mines Act 1901 (a piece of legislation passed partly in response to the Brunner Mining disaster in 1896 and partly as a consequence of the political stance of Richard (King Dick) Seddon (New Zealand PM 1893-1906) who as Minister of Mines in the Liberal Party government in 1891 stated that: "so far as our mines are concerned, we have given away our birthright. Coal is the motive power of all our industries and our...mines are held by private individuals" (Barker, 2001, p.39)). This legislation established the State Coal Mines Department to carry on the business of extracting coal in direct competition with private companies. Very quickly, this Department came to dominate the industry.

This Department continued to operate the majority of New Zealand's mining operations until 1987 when the assets were "sold" to Coal Corporation of New Zealand, the forerunner of Solid Energy. For the purposes of discussion around governance issues for SENZ, it is significant that State Mines (along with other activities that became SOEs) was not only a trading arm of government but was also for many an integral part of a New Zealand-style "social contract" (Dillon, 2010). (For the purposes of the discussion, the term social contract is used to describe a situation where, in order to permit a society to operate, individuals tacitly agree to give up some rights they would otherwise have as individuals (such as the right to live the way they wish) in consideration of the state to agree to honour and respect the remainder. (Rousseau, 1762)).

To explain: for around 100 years from the 1870s and the emergence of the "Vogel Plan" (government policy named after the Premier of the day, Julius Vogel, that involved borrowing overseas to build New Zealand's infrastructure) the New Zealand state had been heavily involved either directly or indirectly in construction and exploitation of natural resources, including water (specifically the generation, transmission (in both aspects of which it had the monopoly) and sale of hydroelectricity, gas and oil, other minerals such as gold and forestry. Government owned and operated the railways, energy generation, communications, national airline and inter-island ferries, was active in the financial sector (insurance and banking) and supported farming and other export – oriented industries (via input and output-based subsidies, tax concessions and import restrictions). By 1984, the New Zealand State sector was absorbing 20% of gross investment and 12% of GDP (State Services Commission, 1998).

This is important because participative and interventionist government policies encouraged either overtly or by implication an expectation that even arguably commercial decisions or policies would frequently have a distinctly social flavour (which was integral to the “social contract”). Inter alia, Government departments running commercial operations could be ordered to take on the unemployed to reduce the numbers out of work (most notably by Robert Muldoon, PM from 1975-1984 and the beginning of the neo-classical economic reforms), policy instruments used for social planning and regional development purposes (early examples of these being the state development and control of hydro power resources (Birks, 1924) and the so-called “country [voting] quota” to maintain rural populations and political voice). State organizations were also not only some of the biggest employers but were frequently also responsible for providing, supporting or subsidising much of the industrial and professional training, these including the Railways (engineering, maintenance, metal fabrication and construction), State Coal Mines (metallurgy, management and prospecting) and the New Zealand Post Office (electrical engineering and communication technology).

However, things changed when, under the Labour Government 1984-1990 and steered by a small band of reformers wielding a neo-liberal economic philosophy, New Zealand embarked on a fundamental and “ferocious” (Hazeldine and Quiggan, 1997, p.18) restructuring of the public sector (also see Wallis, 1997; Bale and Dale, 1998; Farrar and McCabe, 1997). The theme underlying this restructuring was that there should be no distinction between the forces driving public versus private sectors.

It was almost inevitable, therefore, that the Tsunami of reforms beginning in 1984 (Atkinson, 1997) would have not only resounding and fundamental economic implications but also social and political ones (Kelsey, 1999), especially as these reforms involved the dismantling of the Australasian orthodoxy of state development that had existed for the previous 90 years, and its replacement by monetarist policies championed by Milton Friedman and the Chicago School of Economics (Smith, 2005). Many commentators, critics and citizens saw this process as heralding the end to the social contract. Government operations were perceived as having no greater responsibility or sensitivity to their communities as did those of the private sector, sometimes less (for some indication of the immediate impact on communities, see Kelsey, 1995). This impression was borne out by the refusal of the Courts in the few cases that have been brought (*Federated Farmers of New Zealand (Inc) v Ors v New Zealand Post Office and Anor*

[1992] 3 NZBORR 339, *Te Heu Heu and Tuwharetoa Maori Trust Board v AG* [1999] 1 NZLR 98 and *Auckland Electric Power Board v Electricity Corporation of New Zealand* [1994] 1 NZLR 551) to hold that s4(1)(c) of the Act (referring to social responsibility) was a specific expectation placed upon SOEs because of their state-owned status and one that could be prescribed via the courts.

It is against this background and within this ideologically market-driven philosophical framework that steps were taken to detach the commercial activities undertaken by the state (and by local authorities but that is a different story) from the Departments and Ministries historically responsible for those operations and to have them operate instead like private enterprise. State Mines was one of those targeted for change. The next section provides an explanation of the applicable legislative framework (most particularly relating to governance) and a rationale for the changes affecting this industry.

The Creation of the State Owned Enterprise: The Corporatisation of the New Zealand State Sector²

Hon. Geoffrey Palmer (then Deputy Prime Minister, AG and Minister of Justice in the Labour Government) introduced the State Owned Enterprises bill thus: “the economic performance of state trading enterprises must be improved....The equivalent of 10% of New Zealand’s 1986 income went into the Post Office, the Ministry of Energy, the Forest Service, the airways system, and the trading activities of the Department of Lands and survey. The net post-tax return...on the investment...is exactly nothing.” (reported in the NZPD Vol. 474, 1986:4733).

In brief, the important provisions of the Act are intended to ensure the governance of SOEs mimics those players, procedure and practice applied in privately –owned companies. It is emphasised that not only are such companies subject to the provisions of the SOE Act but also any other relevant legislation that applies to companies (or other businesses) operating in New Zealand (Luke, 2009), the Companies Act 1993, the Commerce and Fair Trading Acts 1986, the Consumer Guarantees Act 1993 and the Employment Relations Act 2000 being some of the more important. However, because of their nature and characteristics, it is inevitable that

2 Not all state enterprises are the same. As well as SOEs (registered companies 100% owned by the Government) there are those where some of the shares are in private hands. In addition, some crown entities, while not SOEs, are run as though they are and in accordance with the same expectations of performance and accountability. As SENZ is an SOE, the discussion in this section (and in other places where it is relevant) will be confined to organizations that are subject to the State Owned Enterprises Act 1986.

there will be differences between SOEs and private companies: differences that affect governance.

First is the matter of the nature and role of shareholders. In the private company subject to the provisions of the Companies Act 1993 and its related legislation, shareholders (who may differ in purpose, size of holding and nature of shares held) have the right to trade shares (with some limitations and restrictions if present in the company constitution) and to partake (albeit in a somewhat restricted fashion) in the governance of the enterprise. Inter alia, such activities or involvement include receipt of the annual report (including the audited financial statements), the right to attend and participate in discussion and voting at a general or other shareholder meeting and the right to vote on proposals from the board that significantly affect the asset backing of the company or to put the (solvent) company into liquidation.

Things are not so simple (or perhaps complicated) for an SOE. First, the shares are not freely tradeable amongst interested investors. Instead, shares in SOEs are not held by the ultimate shareholders - the body of New Zealand taxpayers. (That the taxpayers are indeed the shareholders was a point made clearly and repeatedly during the debate on the first reading of the bill in 1986 – for example by Hon. Stan Roger (the Minister of State Services) “As well as improved organization and performance [the bill] provides for greater accountability to shareholding ministers and ultimately to the public” (reported in NZPD Vol. 474, 1986:4728), Dunne “[SOEs need to be managed to ensure] the maximum possible advantage to their shareholders, who are the people of New Zealand” (at. 4735) and Bill Birch (National party opposition) “it is the people who are the true shareholders” (at 4738) but by the Government as sole shareholder (or more correctly by two members who hold executive office (the Ministers for State-owned Enterprises and (normally) of Finance)) (COMU). This shareholder role is both separate from, and additional to, those normally associated with Government (e.g., industry regulation/taxation/purchasing – the “rules of the game”).

Managers are charged with making strategic decisions using similar criteria to those applied in the private sector. Such criteria can be referenced to directly financial concerns (particularly rate of return and cost of capital), or non-financial (or at least indirectly connected to financial considerations), including commercial regulation, market logistics, business risk and opportunities. History shows that moves to put the SOE into liquidation (or to privatise, or restructure) will come from

the shareholder rather than from the board. Such evidence comes from examples such as Telecom (the first to be privatised in 1991) and Electricity Corporation of New Zealand (the electricity generation company that pursuant to government reforms of the energy sector was originally split into two companies with Contact Energy privatised and then into three, including Mighty River Power, which is at the time of writing up for partial privatisation). The one exception is probably Terralink which was put into receivership on the request of the Board after losses incurred on a contract with EDS and following the refusal by government to bail it out. It was subsequently sold in 2001 to a consortium of Animation Research, New Zealand Aerial Mapping and software expert Mike Bundock and continues to operate as a private company (Barton, 2001).

The second way in which governance structures differ as between a private company and an SOE emerge from the power relationship between the Board of Directors (as the central structure to the governance process) and the shareholder(s). Depending on context and relative size of holding, shareholders in a private company may have very little power over directors and their strategic decisions. For most of those in a company with diffuse shareholdings their participation tends to be confined to discussion at the AGM over the contents of the annual report and the directors' reporting on future plans and on voting on resolutions. They also have the right at this time to approve or reject (but not to change) a dividend recommendation from the board, approve or reject individual candidates for board positions (who are often present directors standing for re-election and/or those identified as candidates by the other members of the board). It also might be the case that a large single shareholder (such as an institutional shareholder) has the power to appoint a nominee director who then sits on the board. The final main governance power for shareholders is approval or rejection of the board's recommendation on the auditor. Obviously, the process may differ somewhat for a closely held company, depending on its size and nature.

In SOEs, first, the members of the board are appointed by the shareholding ministers (with no input from the electorate – the ultimate shareholders) with names of potential appointees potentially coming from Ministers in cabinet and by the COMU from those on a variety of nomination databases (its own plus those created by the Ministry of Women's Affairs, Ministry of Pacific Affairs and others). Potential directors are required to have governance, senior management or similar experience (COMU, n.d) and the boards (unlike the majority of publicly listed companies in New

Zealand) have reasonable levels of gender diversity (all SOEs have women on their boards, some of whom are in the Chair). There is effectively no “competition” amongst prospective candidates aside from the opportunity for shareholding ministers and the potential candidates to both assess the position and the “fit” of the candidate to that position: prospective appointees can be asked for their views on future direction for the companies. Present chairs are consulted as to new director appointments and are expected to share those ideas (or presumably seek input) from other members of the board. The level of dividend is also either stipulated or influenced by the shareholder as is the level of debt leverage (even where the board is in opposition to such levels).

The duties of directors of both SOEs and private companies are (in line with the concept of equivalence) specified in the Companies Act ss131-138 – including the duty of care and a duty to act in good faith and in the interests of the company, for a proper purpose, to comply with relevant law and the constitution of the company, not to trade recklessly and not to misuse information for their own purposes. Boards in both instances are also responsible for appointing the CEO and for negotiating the terms of his or her contract of employment. In addition, (and for some commentators theoretically), SOEs, just like private companies, are exposed to those forces that shape the markets in which they operate. These forces include generally applicable legal rules and parameters to acceptable conduct. Consequently, competitors, customers, financiers, employees and others who might be affected by its operations can expect an SOE to play by the rules of the game. (The use of “theoretically” above acknowledges the views of critics that the purported exposure to market discipline is seriously hampered in many cases by such realities as a limited market size, restricted sources of capital and the exercise of political will (Marsden, Poskitt and Small, 2004; Hosking, 2005)). Apropos of this is the situation that has arisen in relation to the Tiwai Aluminium Smelter. This smelter is owned by Rio Tinto which is threatening to pull out on the back of a failure by it and Meridian (the SOE providing power to the site) to reach an agreement on future energy contract supply. The government has now weighed in on the problem, directly involved in the negotiation process. The justification for this intervention lies in the warning that the value of Meridian (and all other power generators in New Zealand) is in jeopardy if the smelter were to close (O’Sullivan, 2013).

Mechanisms providing for accountability of the board to shareholders are also only in some aspects similar as between SOEs and private companies.

First, both produce annual reports that include prescribed financial and other information. These are made available to shareholders and subject to debate and questions in a general meeting. In addition, if there is a proposal that substantially affects the business of the company or where there is a proposal to alter the constitution, again the shareholders are called on to approve or reject such proposals in general meeting. However, as an additional requirement (or perhaps more reasonably seen as a replacement for an AGM, not part of the reporting mechanism for an SOE), SOEs are also required to submit a Statement of Corporate Intent (SCI) every year. This statement is formulated by the Board and accepted (possibly after a period of negotiation) by the Minister of State Owned Enterprises (on advice from the COMU) and tabled in the Legislature (House of Representatives) upon that acceptance. It includes financial and operational objectives and, importantly, identifies and values any explicit social objectives a Government (as sole shareholder) stipulates that the SOE pursue, and for which the SOE seeks compensation from the Government.

The actual monitoring process of SOEs (as opposed to the private company) is conducted by COMU, a process that is supposed to ensure the shareholding ministers as representative of the Government, remain at arm's length. However, this is not always the result: as mentioned previously, the shareholding ministers have been happy to insist on strategies and policies that are fit with the government agenda.

Given the above, it is timely now to consider selected issues that have affected SENZ in the recent past and, as indicated in the introduction to this paper, have implications for governance of this SOE. This exploration also refers to the theoretical frameworks applicable to governance and its design as a means of evaluating and measuring the implications.

Issues for SENZ and their Implications for Governance

The two issues to be discussed in this section are the Mt William mine (on the Stockton Plateau in Westland) and the debt level controversy alluded to in the introduction. The Mt William mine is a useful example because it raises questions over how a company such as SENZ interprets, prioritises and realises its range of objectives and also highlights challenges that it may be facing in the future. By way of background, Mt William is located north of Westport in Westland, a province in the South Island of New Zealand. It is both historical and environmentally important in being the habitat of various endangered species of flora and fauna (Penwarden, 2012) and is an important part of the landscape. In early 2012, SENZ applied for consent

to expand present mining activities on the Stockton plateau (taking in Mt William) for the purposes of increasing its extraction of high-grade coking coal (Smellie, 2012). This generated considerable debate and not a little opposition (principally from Coal Action Network, The Royal Forest and Bird Protection Society of New Zealand and Environment Network) during the consent application process, a process that culminated in hearings in the Environment Court.

The purpose here is not to examine the consent process. However, some governance-relevant issues emerge. The first of these is related to the fact that the Environment Court ruled that although local authorities should plan for climate change, concerns over climate change should not be taken into account when either itself or consent-awarding authorities (the Westland Regional Council in this instance) are considering applications under the Resource Management Act 1991. This was a matter for Government to address via regulation if and when it deemed appropriate. The ruling was greeted with incredulity by those opposing the mine proposal who described the failure to consider climate change as the “elephant in the room” (Penwarden, 2012). The second governance-relevant aspect is the basis for the application to mine: this being to supply the (largely export) market with high coking coal, an essential input to the steel industry. It and others have made the argument that steel is used in machinery involved in green industries such as wind generation and that on balance the production of coking coal is environmentally beneficial.

The other event with governance implications is the worsening financial situation that is identified in the introduction to this paper. In March 2013 the board of SENZ informed its shareholder and COMU of this position, a consequence of a strong New Zealand dollar and falling international prices (of about 40%) for coal. The CEO, Don Elder, resigned from the company but has been retained on his previous salary as an advisor until a new CEO can be appointed. Consequent investigations and a parliamentary Commerce Committee hearing have led to the following disclosures, statements and revelations, all of which raise serious questions. First is the point that under the previous Labour Government (in 2007), SOEs were advised that as commercial operators it was appropriate they assume reasonable levels of risk in order to provide a reasonable return on assets (given the fact that at the time some SOEs had not paid significant, or in some cases any, dividends to the government). On assuming Office, in April 2009 the National-led Government gave a similar message, with Bill English as Finance Minister being quoted as saying “they need to get better

returns than they have got” (Hunter, 2013) (also referred to in this opinion piece was the lowly dividend record for SENZ from 2005-8 at \$0, \$20m, \$0 and \$0 although it is likely that given the recorded revenue in those years, SENZ was spending considerable amounts on assets, development and staff costs) (Hunter, 2013). Given the increases over the ensuing period in coal demand (and therefore prices) it seemed reasonable that SENZ could take on more debt – by 2012 the debt level was around \$275m or about 25% of assets and \$100 million more a year later.

There is some dispute as to how the decision to increase debt (from \$33m occurred). SENZ alleges that it was pressured by the Government to increase debt levels after it declined a request from the board for an injection of some \$27 billion over a period of years (Satherley, 2013). The Government has denied these allegations, instead putting the blame on the board. It also questions the advisability of the decision given the fact that the positive projections for future earnings over the range of energy resources the board was providing did not accord with those of similar companies in the same industry (Hunter, 2013) (this claim somewhat at odds with reports of an expression of disappointment in a letter sent by Simon Powers, then Minister of SOEs in 2009 to the Board as to the negative predictions it was making as to future earnings and profit levels (Satherley, 2013)).

Overall, a charitable view could be that the debt levels were reasonable in the context of the time. After all, the 2012 level was only 25% of total capital. What is more important in terms of the immediate discussion around governance is the way in which that loan money was spent. As well as committing to the expansion of its coal mining operations in Huntly East, and undertaking other capital expenditure, SENZ used it to fund diversification into other energy-related areas such as lignite coal (or the purposes of gas extraction and the production of fertiliser) and investment in renewables, including bio-fuels and wood pellets (Berry, 2012), and bought out Spring Creek Mine. All these have now been shut, sold or cancelled (in the case of the lignite developments and other developments to the tune of around \$100 million) and miners made redundant (Ford, 2013).

These issues could arise for a privately held company but perhaps raise more questions in relation to an SOE such as SENZ as, regardless of intent behind this particular model, the characteristics of such companies and the attitudes and expectations of those dealing with them can be quite different.

First is the matter of direction and philosophy that drives the SOE and its activities and decisions. As a reminder, the reform drive that began in

the 1980s was based on the premise that the public sector, like the private, should assume managers were “self-seeking individual agents operating with relentless opportunism in an environment fogged by uncertainty and private information” (Hazeldine and Quiggan, p.18). Agency theory concepts should then be used to design governance systems for not only commercial but other state operations.

The SOEmodel is therefore structured on those ideas. Consequently, its assumptions (described elsewhere) seek to control the behaviour of the CEO of SENZ (who makes the operational decisions on behalf of the board and ultimately the shareholders). It is also arguable that the board is also an agent – acting on behalf of shareholders – but as identified above, shareholders normally have only limited means of monitoring and determining the focus of the decisions of the board, and even less when it comes to the CEO.

However, despite its influence in the reform of the New Zealand public sector, it is important to note that Agency Theory has come under considerable criticism for its failure not only to ensure the agent (CEO) acts in accordance with the desires of the Principal (shareholders) in the context of a privately held company (where it was first applied) but also, increasingly, for its failure to address issues around governance in different contexts, including the public sector (again discussed elsewhere) . It also does not offer any explanation how the element of sustainability of a firm is addressed.

In this particular context of SENZ, Agency Theory can be criticised for its failure to take into account the role played by the organization in society, for the reality that shareholders are far from univocal, and for its failure to address sustainability. These elements will be discussed in the next section. At this point, however, it is relevant to introduce some alternative governance frameworks that have been proposed as more responsive to the broader issues around corporations and their functions and more relevant to their operations. These frameworks to be considered are based on stakeholder and institutional theories (there are others but these tend to be most considered).

Stakeholder Theory:

The stakeholder perspective recognises that there may be multiple principals (shareholders) with heterogeneous interests and objectives. In addition, proponents consider the range of stakeholders to include, but not be limited to, owners or investors, thus offering a complicated picture

of multiple stakeholders with divergent interests, including employees, customers, suppliers, creditors and lenders and the wider community (Freeman, 1984).

Increasingly, stakeholder interests and concerns are shaping the decision-making process, not only in the public sector and NP sector (where it might be assumed) but also in the commercial sector. Arguably, and in view of the fact that regardless of philosophical framework, SOEs such as SENZ are still owned by the New Zealand taxpayer (and are part of the history of socially-driven state economic participation as described in the introduction), there is an undercurrent of discourse that assumes that they will not only participate in the economic activity of the country but also ascribe to its values – in New Zealand’s case these officially and consistently include environmental responsibility and sustainability.

But, and it is a big but, there are clear difficulties involved in connecting such societal values with governance of SOEs. First, there is the matter of stakeholders communicating such values to those who could be expected to listen – those making the decisions (board and CEO/management). The reason why this is an issue comes from the structures, relationships and power distribution. To explain: shareholders are identified as one of the “big five” stakeholders (Freeman, 1984) - others being employees, communities, suppliers and customers- and their decisions are likely to have a large influence on the strategies and policies of a company in the private sector, not so much because of their direct legislated power in the process but more because of their investment market-driven decisions. On point is the reaction of investors to negative news about Body Shop’s environmental and trade policies (Entine, 1994), a reaction that saw a 50% drop in Body Shop’s share price (albeit temporarily). The extent to which other stakeholders such as customers, suppliers (of debt finance, goods and services), communities and employees can be “heard” will depend on circumstances or where legal processes permit (such as in the case of a resource application hearing pursuant to the Resource Management Act 1991).

However, there is not necessarily the same connection or flow of information in the case of SOEs. Assuming taxpayers are the shareholders, there is in effect two layers of “agents” (or possibly three if you count COMU) between them and the CEO (Government and the board), neither of whom are responsible to shareholders directly, or indirectly via some monitoring system (save for the electoral system that is highly delinked from any information or feedback system between shareholder and board).

Other stakeholders (communities, employees et al.) normally have even less opportunity to communicate directly with the company (except in the same circumstances as identified above for private companies) while customers can only do so via exercising choice – which is only possible where there is one (the irony here being that one of the main rationales for retention of the SOEs in state ownership in the first place was that some were operating as natural monopolies). Even where choice is available, of course, such an exercise can be interpreted in different ways, not necessarily as disapproval for what the company is doing.

However, insofar as communities are concerned and given the above discussion it is interesting to note the reaction to SENZ bid in 2012 to purchase the assets of the defunct (and notorious for being the cause of death for 29 miners, whose bodies remain buried) Pike River mine from the receivers. The West Coast community heralded the news as a “giant step” towards recovering the bodies of the miners (Bayer, 2012), although the following month Elder informed the families that it could be a considerable period (eight years or more) before any work could be commenced (Mussen, 2012). At this point, there were threats to blockade the mine if any work to take coal was performed with no commensurate scheme for body extraction. When Ministerial approval for the purchase was granted in July 2012 it announced that SENZ had signed a body recover deed whereby it agreed to devise a plan for recovery (Ministry of Business, Innovation and Employment, 2012), a result that suggests political pressure was placed on the company to enter this agreement, although, apparently, not for the purchase itself (Mussen, 2012b). (It is difficult to think of any other reason. There were no other interested parties in the mine: all had pulled out. Also SENZ had already informed families as to the unlikelihood of, and considerable delays in, any efforts at body recovery (as mentioned above) and was already seeing a reduction in world prices for coal.)

At the same time it should be noted that SENZ is seeking a modification to the license for Pike River that would allow it to conduct open cast rather than underground mining. This is of concern given that its proposal could involve extending such a mine into the Paparoa National Park (Fisher, 2013) and raises questions as to the governance priorities for the company and the board. It also highlights the dilemma faced by Government; as the de facto shareholder seeking a commercial rate of return from an investment that potentially pursues a line contradictory to a long-standing political ethos – sustainability and environmental awareness.

Finally suppliers – most specifically of finance but others as well – are caught in a double bind. On the one hand they are given the message that the company is to be considered the same as any other – able to fail, make its own decisions and more generally be subject to the same rules and market disciplines as all others. Again this was articulated by Palmer when the bill was introduced in 1986: “The eight new corporations set up...as fresh SOE will be capable of going broke” (at NZPD,1986, Vol. 474:4739-40). However, it is significant that only one SOE has ever been allowed to fail – Terralink (which as identified earlier, was sold to private interests and is now doing very well) while other Government-owned, previously owned or partly owned companies have been bailed out or otherwise had pressing revenue-affecting issues addressed. Air New Zealand (after the Ansett debacle) and New Zealand Rail (on the Wisconsin Rail consortium pulling out) are two high profile examples. Of further relevance is the fact that as mentioned previously, and at the time of writing, the government has weighed in on the negotiations with Rio Tinto. Also, and more specifically, between 1987 (with the creation of the first nine SOEs, including Coal Corporation) and 1990, the Government invested \$95 million in the State Coal Mines as part of its liquidation process – therefore meaning that Coal Corporation was effectively paid to take over the assets. These examples not unreasonably suggest to suppliers that there is not only a willingness for Government to get directly involved in the strategy and management of the SOE where it perceives it politically opportune but there is also an implied Government guarantee supporting the activities and ventures undertaken by SOEs – a very different situation to that which normally applies to private enterprise. Interestingly in this regard is a comment by Hon. John Key (as Prime Minister) as reported by TV3 News:

...there’s no Government guarantee from the Government to Solid Energy. They’ve made commercial lending arrangements with Solid Energy, and they have to assess those on the merits of the company... If you’re a banker, you make money in the good times, and when you make loans that are successful and repaid – but you can’t just say, ‘I don’t suffer any losses if something goes wrong.’ (Satherley, 2013)

What is also of note however, and despite the above, is the further indication from Key in the same interview that he is not ruling out a taxpayer bailout – a hint at continued Government support for SOEs in line with past history. Given also the information that has emerged around the insistence by successive Governments that returns to Government should

be increased, thereby setting the environment for greater debt leverage, it is understandable if financial supporters would assume Government should shoulder some of the responsibility.

A third theoretical construct mooted for governance is Institutional theory: the theory that, in its various iterations locates the company as either an institution with characteristics and relationships of its own that determines how governance should or does work (Old Institutional Theory) or as a product shaped by such institutions as laws, rules, expectations and norms (New Institutional Theory).

Institutional Theory

As explained previously, Selznick (1996) explains that this theory: “is a voice of resistance to [a]...culture of short-sightedness, offers guides to thinking about corporate responsibility, and brings into question the goal of maximising profits or returns on capital” (Selznick, 1996, p. 272). Instead of treating the corporation (or company or firm) as a passive nexus for enabling contracts between self-interested economically rational beings (the basis of agency theory), institutional theory gives it a much broader role as an adaptable social system (Mason, Kirkbride and Bryde, 2007), thereby also empowering those involved in such organizations to respond to other groups within that organization and outside. The theory subsumes stakeholder theory (Parkinson, 2003) with its assumption that stakeholders of various types, power and location affect both formal and informal processes within the organization, and further acknowledges that stakeholders (or more generally participants) have a culturally-oriented impact on the institutions that control behaviour and reward outcomes. Before exploring this theory further, some preliminary questions need to be addressed.

Briefly, in this context (and depending on which strand of the theory), “institutions” refer not only to the organizations themselves (Selznick, 1996) but also to those social concepts that underlie them or as North (1997, p.23) explains, they are ‘the rules of the game...they are comprised of formal rules (statute law, common law, regulations), informal constraints (conventions, norms...and self-imposed codes of conduct) and the enforcement characteristics of both’. Chhotray and Stoker (2009, p. 64) specify that those rules and constraints have three key characteristics: they have the ability to govern relationships between individuals and groups, are either voluntarily accepted or enforced by some external agency and are predictable.

North (1997, p. 23) describes ‘neo-classical economists [including those wrestling with issues of agency]... impliedly assum[ing] that institutions ...do not matter, and that static analysis embodied in allocative efficiency models should be the guidance to policy’ (also see Chhotray and Stoker, 2009, p. 159 for their point that economic theory often overlooks the relationship between the legal system and economic development). Therefore, the only reason for their consideration would be due to their effect - negative, neutral or positive – on the cost of transactions, and therefore their implications for the principal objective: maximising shareholder (short-term) wealth.

Institutional theory has a reflective function. It can inform institutional design (Harriss et al., 1997, p. 2). More generally, there is implicit acceptance that a framework of formal ‘rules’ may be the best option within a particular cultural or economic context to cope with market failure (Harriss et al., 1997). Such failure could be found in a weak or non-existent equity market (where participants are unrestrained in their misuse of information – insider trading or where the nature of the company (such as an SOE perhaps) means there is no or distorted market discipline), cultural norms or where weakness of the economy and its vulnerability to domination by transnational business organizations prompt a Government to respond with changes to formal rules – including regulations criminalising certain market behaviours, providing import controls or offering other sorts of protection (including minimum and maximum incomes, levels of foreign ownership or other participation in business (Nwabueze and Mileski, 2008).

Institutional theory sees the situation around choice as complicated (compared to agency that identifies economic rationality as the one driver). North (1997, p.18) posits that choice is multifaceted because ‘ideas and ideologies’ also play a part. Institutions may reduce the levels of uncertainty that might otherwise result from those ideas and ideologies (North, 1995) but does not eliminate them.

Despite the oft-stated rhetoric that the SOE model is more “efficient” because it focuses on commercial measures of performance as does any company or other business in the private sector, this statement is not necessarily accurate. SOEs are subject to the political aspirations and ideologies of their political masters (as in the case of SENZ and the body recovery plan, the expectation that they pay a greater dividend (and take on more debt) and as in the case of those SOEs such as Mighty River Power targeted as candidates for partial or full privatisation), and despite the existence of structures such as COMU, the relationship between the Government as shareholder and the Government as regulator is inevitably

blurred. Private companies too are not always focused on economic performance but frequently seek to respond to environmental and social concerns (albeit possibly for a commercially cynical purpose – to increase market profile and/or share). The concepts behind institutional theory, therefore, can be considered to have an impact on governance of SOEs in New Zealand and consequently create a picture that is more complex and fraught in terms of how that governance works.

Given the above, it is appropriate to raise questions as to how the governance approaches, issues and foci that have relevance for SENZ may affect the future of this company. These questions are asked and briefly answered in the next and final section of this paper.

The Future of SENZ: **WHERE TO FROM HERE? AND WHAT DOES IT SUGGEST FOR OTHER SOEs?**

Q. Governance or Government?

A. SENZ is a government –owned company and it is difficult for either company or government to get past that. It is inevitable that while it remains as one, its strategies, decisions and policies are going to be associated with the state. Consequently, contradictions and conflicts are likely to be highlighted and explored for their message on government policy. Government also struggles with the conflicting messages around the governance of SENZ and who is ultimately responsible. This is not only in terms of sources of finance and the rights of those in this situation but also rights and expectations of those (stakeholders) dealing directly with SENZ. History suggests that when the going gets tough, Governments get involved, perhaps for good reasons (given the importance of some of these SOEs to New Zealand society and the economy and for their pivotal importance to Government policy). Crucially, the threshold for any new entrants is high in such industries as energy generation and therefore arguably, competitors are unlikely to be waiting in the wings for a market opportunity. Also crucially, the failure of an SOE has political ramifications both direct (loss of dividend) and indirectly (loss of credibility and trust in Government economic management).

Q. Is it logical or reasonable to regard SENZ as just another company with the same issues and answers?

A. SENZ as an SOE is in a difficult situation. As explained above, its governance structures are modelled on agency theory yet increasingly companies in the private sector are under pressure to look wider for views and participation. Stakeholder and institutional concepts are shaping that

broader gaze while feedback, market behaviour and societal pressures are forcing companies around the world to rethink their policies and rhetoric – redefining and reemphasising priorities to focus more on addressing sustainability and the environmental/social implications of their practices. Whatever the drivers for these shifts, and whatever the merits of such claims (and the criticisms levelled against them) the increasing reference to ratings scales and evaluation measurements is indicative of the growing willingness of such companies to address the concerns of their stakeholders and their search for validation of this willingness and credibility of their claims. Given that, it is interesting to see SENZ referring to “sustainability” in various places in the 2011 SCI (the latest available), most specifically thus:

We will manage our business in accordance with sustainability principles that consider our specific expectations for value, our people and communities, health & safety, the environment and our reputation. For our business to be sustainable in the long term we will carry out all our activities in such a way that we achieve our current business objectives without unreasonably compromising our ability to meet our future objectives. We will manage our business in accordance with sustainability principles that consider our specific expectations for value. (SENZ, 2011, p. 3)

It is also of interest to see its Environment Report (2010 – again being the latest version available). In the report SENZ describes how the (positive) advances have been assessed – “by a cross section of our own staff, contractors and expert consultants. External organizations, including Regional and District Councils, the Department of Conservation, Fish and Game and Iwi groups [as external stakeholders] were also invited to take part” (SENZ, 2010, p1).

Does the above then mean SENZ displays similar responsiveness to societal pressures and expectations as do others? To answer this is in part speculative because there is a range of variables, many shaped by the immediate context (the financial problems). However, what is noteworthy is that the retrenchment presently being pursued by SENZ is focused largely on the renewable energy initiatives (wood pellets and biodiesels) and on community – level sponsorships. The reaction of SENZ is to pull back to its core business – that of coal mining (an industry that is not seen as sustainable in any sense of the word).

Q: Should processes in which SENZ is involved have implied expectations over and above legal requirements?

A. The position of SENZ as an SOE might arguably be seen as carrying with it certain expectations over how processes should be pursued. The particular example of the Environment Court ruling that climate change should not be considered in the resource consent process is a good example of where such implications colour not only the perception of the company seeking such consent but also that of Government. If a government willing to intervene for political reasons in SOE governance (as in the instance of the debt leverage in SENZ but also in Meridian Energy in its stalled negotiations with Rio Tinto) declines to do so when the national environmental credibility is at stake, what does that suggest as to its true position? More worryingly, is it suggestive of a situation where a Government could use the SOE model to spin-off unpopular activities and policies, thereby maximising its own political capital and credibility (analogous to where a company succeeds in privatising gains and socialising losses as a means of protecting its financial returns).

Conclusion

The above discussion and analysis draws on the example of SENZ as an example and illustration of the workings of the SOE model in New Zealand. The principal challenges facing this company, although in some ways unique, also carry implications for other SOEs in New Zealand and, arguably SOEs in other national contexts. The main message that comes out is this: either an SOE should be regarded as an arm of Government (with social obligations and involvement that are inevitably attached to such a status) or they are not – in which case governments should ensure the arms-length governance processes should be diligently maintained. To do something other than this both confuses and concerns those who are, in the end, the shareholders.

Discussion Questions:

1. What are the main differences between private companies and SOEs where those differences affect governance of those enterprises?
2. What do you think is the appropriate role on responsibilities of SOEs?
3. From the perspective of a specific stakeholder in an SOE (a creditor, customer or employee being three possible examples) compose an argument either for or against privatisation of the SOE.

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BIOGRAPHY

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Chapter 25

**Instituting Good Governance in
Indian Public Sector Corporates***Dr Roopinder Oberoi***Abstract**

This paper draws from the renewed interest in the role of government in an era of augmented political, socio-economic and environmental interconnectedness, which is confirmed internationally in the course of particular governmental responses to issues facing the world especially as the global financial crisis unfolds itself. The paper seeks to identify and gain consensus on the pillars of good corporate governance for public sector enterprises. It briefly outlines the process undertaken to reform India's public sector corporate governance laws. The paper also looks at the institutional and regulatory framework for the central public enterprises governance of India, considering in particular the evolution of official principles and practices that has taken place during the last few decades with spotlight on post liberalisation period. It also highlights the permeability of government precincts and the implications of this for public sector accountability.

An evaluation of India's corporate governance reforms with reference to central public sector enterprises demonstrates that though wide-ranging restructuring have been instituted, there still remains noteworthy drift in functioning and enforcement. The paper articulates concerns that challenge in governing public enterprises might still prevail because PEs are shaped by unique politico and social forces. These forces include the traditional closed ownership structures, overlapping jurisdictions, cross-government activity, an ineffective institutional and regulatory framework to support enforcement efforts, weaknesses in investor access to the courts, and political pressures etc.

Key Words: Public Sector Enterprise; Governance Framework; Good Corporate Governance Indicators; Agency Problem.

The year 2009 has been the year of the public sector world over. As global corporations collapsed and reeled under the impact of the financial crisis, governments yet again are assuming centre stage and have been thrust into the role of actively ‘governing’ and ‘bailing out’ corporations. In India too, the government played its part in pulling the beleaguered Satyam³ out of the troubled waters and through its monetary and fiscal policies tried to steer the economy during current crisis. Despite privatization the centre and state owned enterprises control vast swaths of the national GDP of India.

India, being a developing economy, has adopted a mixed economy framework where the role of the Central Public Sector Enterprises (CPSEs) is as important as private sector enterprises. With the opening of the Indian economy for the private players, CPSEs now have to compete on a level playing field with the private sector by setting industry benchmarks and international standards and evaluate their performance. The Government of India (GOI) has taken a number of steps over the years to improve the efficiency and performance of its CPSEs.⁴ Given the enablers and constraints prevailing in the public sector, the CPSEs have to address the emerging policy and regulatory initiatives, respond to critical market events and continue to improve operational performance.

Corporate governance has been an important part of GOI’s broader CPSE and economic reforms, aimed at improving the performance and competitiveness of some of India’s most important national assets, allowing companies easier access to the capital markets, and making companies more transparent and accountable. The underlying goal is to reorient the state’s role away from as a major market player to more of a market regulator and away from day-to-day management of CPSEs to en route for exercising its core ownership rights based on sound corporate governance principles.

The image of mammoth enterprises essentially laggard and eating into the exchequer is gradually getting altered. Over the past three years, the market capitalisation of listed Public Sector Enterprises has more than doubled thereby signifying the success of the first wave of PSE disinvestment. The contribution of CPSEs in terms of turnover to the GDP has ranged between 20-25 percent during FY 2005 – FY 2011.⁵ In accordance with the Government’s philosophy to develop people’s ownership of CPSEs, many CPSEs were divested through a combination of strategic sale to private partners as well

3 See James Fontanella-Khan, *Timeline: The Satyam Scandal*, Fin. Times, Jan. 7, 2009, available at <http://www.ft.com/cms/s/0/24261f70-dcab-11dd-a2a9-000077b07658.html>. The Satyam scandal has been described as India’s Enron.

4 CPSEs which are defined as non-financial enterprises with a corporate form in which the national government holds, directly or through other CPSEs, 51 percent or more of ownership.

5 DPE; Public Enterprise Survey, 2010-11, Department of Public Enterprises; GOI

as public offers. The disinvestment has led to significant monetization of the Government's investment in CPSEs and enabled sharing of the value created with the public at large through listing of CPSEs on stock exchanges.

However, still the lack of an effective corporate governance structure for CPSEs often inhibits the transparency and free functioning of these enterprises. The problem becomes more severe with multiple reporting agencies which have their separate agendas. Often a clash between agenda of political parties and objectives of CPSEs impairs the growth and autonomy of CPSEs. Taking cognizance of these malaises and in order to improve public accountability in PSEs, in June 2007 the Department of Public Enterprises (DPE) brought out comprehensive "Guidelines on Corporate Governance for Central Public Sector Enterprises".⁶ India is one of the few countries having adopted such guidelines following discussion with all relevant stakeholders and consideration of all relevant laws and regulations.

By releasing the voluntary guidelines on good corporate governance, the government has articulated a strong desire to improve the governance standards in India. As the government's disinvestment strategy gathers momentum, there is a legitimate need to develop the intensity and depth of transparency, and accountability within PSEs. Furthermore Government as the principal shareholder and promoter in Public Sector Enterprises ought to be setting the bar of corporate governance standards and practices. This is imperative because the standard of governance in corporate India is linked closely to the overall governance system.

Unquestionably public sector enterprises are unique and has its own set of strategically defined goals and way of functioning and hence, demands for a distinctive set of governance policies. However, explicit corporate governance guiding principles need to be unconditional in nature to be relevant over a wide range of public companies to provide a common performance evaluation parameter. This entails providing requisite autonomy to the public sector along with effective monitoring and it needs to be underscored here ensuring managerial autonomy to the PSUs does not ebb away the responsibility of the government, rather redefines it.

Contextualising the Debate

Since the 1980s, public sector restructuring has matched up with private sector principles and practices and rapidly adopted public

⁶ CPSE governance frameworks and practice is understood in light of good practice based on the *OECD Guidelines on Corporate Governance of State-Owned Enterprises*, and in light of the *2007 Guidelines on Corporate Governance of State-Owned Enterprises* issued in 2007

management approach. The Public Choice School and the sway of New Right Movement brought this change. Osborne and Gaebler's ten principles of reinventing government are clearly directed at creating a results-oriented government and on doing more with less in the public sector.⁷ Managerialism (Halligan 2007) best reflects the first phase in which management became the central concept and reshaped thinking as part of a paradigm change. This was succeeded by a phase that for a time came close to the main stream depiction of new public management (NPM) (Hood 1991), in which the market element was favoured and features such as disaggregation, privatisation and a private sector focus were at the forefront. In turn, NPM was followed, although not displaced, in the 2000s by integrated governance (Halligan 2006). The sequence of reform has run from administration to stages dominated first, by management, then markets, and then performance-based governance. Market principles were applied first to the outer public sector and subsequently to the core public service. The private sector and the market forces were closely related: the exporting of responsibilities to the private sector and/or making the public sector subject to market disciplines; and the importing of business techniques combined with attempts to replicate market conditions internally. Several tiers of markets became accepted within the public sector. (Halligan; 2013)

A central element was creating more business-like operations in the public sector. The movement towards corporatisation from the late 1980s, through either government business enterprises (GBEs) or incorporation as companies, produced significant changes to the status of major organizations (Halligan and Power 1992) The language of corporate governance was aimed to relocate the public sector as both an expression of that and through the need to revisit how to provide a corporate basis for adapting organizations in rapidly changing global environments. (Halligan; 2013)

However, in the era of liberalisation, privatization and globalisation, which was followed by attempt to revamp public sector; Public Sector Enterprises uphold an imperative role in the ownership landscape and in global markets. Public sector governance focuses attention more discretely upon governance within the public sector generally, or a designated level of government in particular. Corporate governance in government must be contextualized and practiced within a range of interconnected systems

7 The publication of Osborne and Gaebler's *Reinventing Government* (1993) profoundly influenced the theory and practice of public administration throughout the world.

and dimensions of governance. The dynamics of corporate governance in public sector is unique and is neither derivative from, nor transposable to, the private sector in absolutist fashion.

There are applications of nuances more generally to public organizations throughout the public sector which need attention. Corporate governance in the public sector centers upon the governance of organizations in that particular sector, as well as upon the more encompassing governance relations and interactions with others, both within and beyond the sector. The applicability of standard corporate governance fundamentals such as performance, conformance and accountability is impinged on by the prism of constitutionalism, managerialism, political control and any prominent organizing theory of public administration. In the public sector context equivalent narrowing occurs when governance attention is focused solely upon the relations between a department's or agency's governing body, its CEO, and relevant ministers of state. Such a limited conception of public sector governance risks overlooking the governance significance and nuances of 'the systems, processes, policies and strategies that direct operations, assure quality, monitor performance, and help manage [board and CEO] obligations to stakeholders' (Barrett 2003).

The ownership structure of firms is an important element of corporate governance, the complex system of legal, institutional and market forces by which firms are governed (Berle and Means, 1932). A firm ownership structure can be defined along two main dimensions. First, the degree of ownership concentration; firms may differ because their ownership is more or less dispersed. Secondly, the nature of the owners; that is firms may be private, government -owned (state owned) and mutual (mixed owned), (Iannotta et al, 2006).

The index of performance measurement to put it simply is the achievement of objectives. Whilst in the private sector entities the objective of profit maximization defines performance, its absence in the public sector entities generates difficulties, even paradoxes, in explaining this concept. Bouckaert and Balk (1991) stated that the opportunity and necessity of performance measurement in the public sector entities rise questions. For Meyer and Gupta (1994) and Jones and Pendlbury (2000), performance in the public sector entities is a paradox. However, Lorino (1995), states that performance can be more encompassing and intangible and can be viewed as what contributes to the improvement of the couple cost-value, and not only what contributes to the diminution of cost or increase of value. This approach concerns three directions of action for the public sector entities;

implementation of strategies allotted to the entities by political authorities, value infusion for the public, users whom the entity addresses to and control of resources that were allotted in order to accomplish their mission. (Tusiime S I K. Nkundabanyanga and Isaac N.Nkote; 2011)

The property rights hypothesis (for example, Alchian, 1965), suggests that private firms should perform more efficiently and more profitably than government-owned firms should. In the case of government-owned firms, as Shleifer and Vishny (1997), point out that while they are technically controlled by the public, they are run by bureaucrats who can be thought of as having extremely concentrated control rights, but no significant cash flow rights. Additionally, political bureaucrats have goals that are often in conflict with social welfare improvements and are dictated by political interests. Majumdar (1998), for example also compared the financial performance of state owned, private owned, and mixed state-private ownership firms and found that the most profitable firms were the private owned, followed by mixed ownership. Majority of other studies (see, Ramaswamy, 2001; Shleifer and Vishny, 1997; Shleifer, 1998) have drawn similar conclusions. (Tusiime S I K. Nkundabanyanga and Isaac N.Nkote; 2011)

How well these public sector enterprises are governed will have a significant impact on their performance and value, as well as on public finances, economic growth and competitiveness. Different economies have systems of corporate governance that differ in the relative strength of influence exercised by the stakeholders and how they influence the management.

More than ever, in India we require public sector enterprises that can be commercial as well as successful in achieving environmental, social, and economic value for society thereby setting the benchmark for the private sector to link business with good governance. If we admit that there are genuine limitations of selling off of PSEs – core of which belong to energy, infrastructure, and industries of strategic interest in national development – then there is perhaps no credible alternative but to improve the functioning of these enterprises. We, then, are back to the old question: how to improve PSEs performance where a change in ownership is unlikely to make much difference.

There is a large (administrative) literature (including many valuable official reports) addressing such a question; much of it dwells on the autonomy and accountability of enterprises posed mainly in terms of administrative controls of the government as the ultimate “owner”, and procedural accountability of the managers. Economic analyses of public

sector performance, however, seem to have largely ignored the institutional ‘black box’, by focusing mainly on the macroeconomic effects of public investment and planning for growth.

At the most rudimentary level, however, the goal of governance of corporates and public sector is equivalent; to install structures of control and management to hold them accountable to stakeholders. In any developing world, the returns from good corporate governance in State Owned Enterprises (SOEs)⁸ should exceed those in the private fold. Obviously, there is a strong interface between good governance and corporate governance in the context of public enterprises as the latter are often used and perceived as instruments of public policy. Indian PM at conference on CPSEs (2007) stated; ‘The revitalization of the public sector is an integral part of our strategy of promoting ‘inclusive growth’. We regard the public sector as an engine of growth, a source of employment generation and as an important source of R&D in our industrial sector. Our Government’s policy has been to remove all irritants coming in the way of the healthy functioning of public enterprises’. Public enterprises should also evolve their own code of corporate ethics and conduct and ensure adherence to such codes. Our Government is working towards limiting the administrative ministries’ role in the day-to-day management of public enterprises. I hope the steps we intend to take will help our public enterprises to become more globally competitive.”

The Standing Conference of Public Enterprises (SCOPE) recognised the need to examine the corporate governance issues relevant to the public sector undertakings in India i.e. those companies in which central government has equity of 51 % and above.⁹ It was acknowledged that the codes, which were referred to often were most appropriate to the private sector and that the infirmities in the public enterprise governance needed a devoted attention.

The Undiminished Role of Public Sector in Asia

The scale and scope of Public Sector Enterprises in many Asian economies calls for specific attention to be given to their corporate governance. Even if their economic significance varies greatly from country to country,

⁸ SOEs and PSEs are used in the text as the lexicon used to describe them may be different in different countries which do not really signify substantial difference in ownership and functioning.

⁹ There will be a greater thrust on performance improvement through the Memorandum of Understanding (MOU) System through which managements would be granted greater autonomy and will be held accountable. Technical expertise on the part of the Government would be upgraded to make the MOU negotiations and implementation more effective. To facilitate a fuller discussion on performance, the MOU signed between Government and the public enterprises would be placed in Parliament. While focusing on major management issues, this would also help place matters on day-to-day operations of public enterprises in their correct perspective”. Available at http://www.scopeonline.in/standing_conference.htm

they still represent a major, if not dominant, part of the economy in some countries (around 30% of GDP in China and 38% in Vietnam). PSEs remain significant in many other large and/or key Asian economies. In India and Thailand they roughly contribute 25% of the GDP, in Malaysia and Singapore close to 15%. PSEs might also represent a not insignificant part of total employment (15% in China, 5% in Malaysia) or of fiscal revenues (25-30% in Vietnam) (Policy Brief on Corporate Governance of State-Owned Enterprises in Asia; OECD; 2010)

PEs remains prominent in energy and network industries such as air and rail transport, electricity, gas and water supply, natural resource extraction and telecommunications. They are often predominant in the financial sector, particularly in the banking and insurance sectors. In addition, in a number of Asian economies PEs are also prevalent or still important in a wide variety of manufacturing or service industries such as aerospace, auto-manufacturing, shipbuilding, shoes and textiles, steel, tourism and leisure. Finally, a considerable and increasing number of PEs are listed on the national stock exchanges. They represent a significant part of the total stock market capitalisation (from around 20 % in Singapore, one fourth in India and Thailand, around one third in Indonesia and Pakistan, to around 50 % in Malaysia and close to 60% in China). In any event it is in the interest of every country to ensure that state-owned assets are well managed; good PSE corporate governance is a key part of that. (Policy Brief on Corporate Governance of State-Owned Enterprises in Asia; OECD; 2010)

Benefits from improving PSE governance are great, but they are difficult to obtain as SOE reforms can be complex and SOEs indeed face specific challenges in terms of governance. They often suffer both from passive ownership by the state and, at the same time, from undue political interference. They also typically face a soft budget constraint, being largely protected from bankruptcy and takeover threats. Their transparency in many cases leaves a lot to be desired. More generally, they have a complex chain of accountability, with remote and not easily identifiable principals. (OECD; 2010)

The potential impact of PSE reform on Asian economies can thus not be overstated. Improving their corporate governance could potentially lead to significant efficiency gains, improvement in the quality of public services, a decrease in the fiscal burden and public debt, and ultimately contribute to overall growth. Expected benefits will also include better valuation of state assets (for potential future privatisation) and/or easier access to capital, both debt and equity, therefore facilitating and securing their international

expansion (when relevant). In addition, it will in many cases improve overall public governance, including through greater transparency. Last but not least, it will ensure more effective competition with the private sector.

Not only in Asia but many countries of the world, public sector continues to play critical role. Many OECD countries believe in the significance of State ownership and public sector. For example; the objective policy statements for the existence of SOEs has been mentioned below to draw home the point.

In Sweden, for example, “The Government’s overall objective is creating value for the owners” (*State Ownership Policy*, 2006).

- In France, the overall objective is “to contribute to a better valorisation of state shares in SOE”. (*Loi Organique sur les Lois de Finance* (LOLF), 2006).
- In the UK, the overall objective of the Shareholder Executive is “to ensure that Government’s shareholdings deliver sustained, positive returns and return their cost of capital over time within the policy, regulatory and customer parameters set by Government, by acting as an effective and intelligent shareholder”.
- In Finland, the core purpose of state ownership is defined as follows: “The State seeks to achieve an economic and societal overall result that is as good as possible” (*2004 Decision in Principle on State’s Corporate Ownership Policy*). What this means in practice is then clarified: “The economic overall result is the sum of the development in value of the shares owned and their annual dividend yield” (*State Shareholdings in Finland*, 2005).
- In Norway, “The purpose of state ownership is to attend to the common good. As an owner, the State also expects these companies to take corporate responsibility and to uphold our basic values in an exemplary manner” (*The State Ownership Report*, 2005).¹⁰

Recent Corporate Governance Reform Initiatives in Asia

Asian governments have been particularly energetic in reforming PSE governance in recent years. Significant and in many cases remarkable reforms have been undertaken covering most areas of corporate governance. Some of these reforms will be briefly described as examples to illustrate the recommendations developed in this document. To mention just a few in different areas: three former planned economies have set up centralised ownership entities, i.e. the SASAC in China in 2003, the SCIC in Vietnam in

¹⁰ OECD; 10 Challenges in Setting Objectives and Reviewing Performance of State Owned Enterprises, OECD, 2007.

2007 and more recently the Druk Holding and Investments in Bhutan. The Philippines pioneered the development of a PSE governance scorecard in 2006, following the adoption of the OECD Guidelines. It has proven to be a very effective tool to press for further PSE reforms, as witnessed by the adoption in 2007 of a breakthrough Presidential Memorandum mandating important governance reforms. In India, the Ministry of Heavy Industry and Public Enterprises has been active in trying to foster better governance in the state sector by issuing in 2007 specific Guidelines on the Corporate Governance of CPSEs (Central Public Sector Enterprises).¹¹ More recently, Pakistan is also in the process of issuing an SOE Code. Meanwhile, in Malaysia, the far reaching and encompassing “Transformation Programme” is beginning to show impressive results. The State Enterprise Policy Office (SEPO) of the Ministry of Finance has developed Guidelines on Corporate Governance of State-Owned Enterprises that set out a main framework for SOEs’ operations in Thailand. More focused initiatives are also interesting, such as the development of a directors’ pool in Thailand. In the area of transparency, Temasek in Singapore has also taken a significant step forward by publishing an aggregate report since 2004. In addition, significant reforms are also underway in Korea which is now profoundly reorganising the way PSEs are governed and monitored. (See Policy Brief on Corporate Governance of State-Owned Enterprises in Asia; OECD; 2010)

But there is still a long way to go to have efficient and transparent PSEs governed by strong boards, active state ownership without undue interference in day-to-day business and fair competition between PSEs and private sector companies. PSE governance reforms need to be supported in the long run to reach sustainable results. They are an important part of the overall corporate governance reforms that are still an “unfinished agenda”, in Asia as well as elsewhere around the world.

11 The Ministry of Corporate Affairs issued the Voluntary Corporate Governance Guidelines in December 2009; Available at: http://www.mca.gov.in/Ministry/latestnews/CG_Voluntary_Guidelines_2009_24dec2009.pdf.

In his foreword to the Voluntary Guidelines, the Minister of State for Corporate Affairs, Salman Khurshid, explained the rationale of these voluntary guidelines, as follows: “The Ministry of Corporate Affairs has been working towards strengthening of the corporate governance framework through a two pronged strategy. Some aspects which needed to be incorporated in the law have been included in the Companies Bill, 2009, now under examination by Parliament. However, keeping in view the objective of encouraging the use of better practices through voluntary adoption, the Ministry has decided to draft a set of voluntary guidelines, which not only serve as a benchmark for the corporate sector but also help them in achieving the highest standard of corporate governance. As we receive feedback from different quarters and gain experience from their adoption, the guidelines can be modified progressively.”

Indian Public Sector Journey

The National Common Minimum Programme (NCMP) under the present government of India envisages a strong and effective public sector and pledges to devolve managerial and commercial autonomy to successful profit making companies operating in a competitive environment. This necessitate for appropriate public accountability of the CPSE managements regarding discharging of their duties and responsibilities keeping in view the fact that huge public funds have been invested in them. The NCMP inter-alia also provides that Public Sector Companies will be encouraged to enter capital markets to raise resources and offer new investment avenues to retail investors. Thus, it is imperative that ethics and probity is upheld in the operation of CPSEs. Good Corporate Governance practices, therefore, should be built into the management systems of CPSEs.

However, the story of India Inc. has not been as self-assured as when it started its reform journey in 1990's, doubts were expressed about whether the public sector can transform itself and compete. In 1991, a small fraction of the equity in selected central PSEs was sold to raise resources to bridge the fiscal deficit. Though quantitatively modest the 'disinvestment' signalled a major departure in India's economic policy. While there have been instances of sale of publicly owned enterprises as running concerns on pragmatic considerations, it is only in the last decade that such sales (and sale of limited equity) acquired the status of public policy.

As the bulk of the public investments were in industries with economies of scale and scope (with externalities that in principle invite considerable regulation), it was only political and economically sensible for political class to go cautiously with these ownership and structural reforms. It is perhaps also worth reminding that the 1990s witnessed a series of frauds in the financial sector that seriously dented the credibility of the stock market, which is yet to recover in terms of participation of domestic "small" investors. After the Harshad Mehta scam, there was, MS Shoe scam, collapse of NBFCs, vanishing companies scam, teakwood plantation scam, collapse of CRB group of financial companies, collapse of housing bubble in 1996, and finally the Ketan Parikh scam in 2000.

These series of allegations of corruption and malpractice in many of these deals, instances of under pricing of assets, favouring preferred buyers, non-compliance of agreement with respect to employment and retrenchment, and many incomplete contracts with respect to sale of land, and assets were widely reported which raised many questions. However two decades later, we are seeing a vibrant public sector that came out well during the

worst phase of the credit crisis on several fronts ranging from financial performance, human capital management to sound risk management.

Post-independence, PSEs were created essentially as vehicles for industrial and regional development, for development of basic infrastructure networks, and employment generation. And after six decades of independence, the importance of Public Sector Enterprises (PSEs) in the Indian economy can never be over emphasized. During the first five-year plan (1950-51 to 1955-56) there were only five CPSEs with a total financial investment (including equity plus long-term loans) of 290 mn, whereas in FY11, there were 248 CPSEs (including 220 operating and 28 CPSEs that were yet to commence commercial operations and excluding seven insurance companies) with a total financial investment of R 6,668.5 bn as on Mar 31 2011, showing a CAGR of around 6% during the same period. (Department of Public Enterprise Survey; 2012)

Public Enterprises still account for over 22 % of the country's GDP, around 6 % of the total employment in the organized sector and over 20 % of direct and indirect tax collections. In India, there are altogether 249 Central Public Sector Enterprises (CPSEs) under the administrative control of various ministries/ departments as on 31 March 2010. Of these, 217 were in operation and 32 under construction.¹²

As in terms of financial indicators, the market capitalisation of the 45 listed PSUs (excluding banks and three companies which were not traded) was R12.6 trillion as in 2012, constituting 20.3% of total market capitalisation of Bombay Stock Exchange (BSE). (DPE Survey 2012) The financial investment registered 15% Y-o-Y growth during FY11. In terms of sector-wise share in their total financial investment, the CPSEs in the electricity sector had the maximum share of around 37.3% as on Mar 31, 2011. This was followed by service sector with 36.1%, manufacturing with 17.9% and mining with 7.3 %.(Department of Public Enterprise Survey; 2012)

To understand the matrix of Public Enterprises in India we can basically categorise them under four broad types based on their ownership structure. These include: departmental undertakings, statutory corporations, government-owned companies and autonomous bodies set up as registered societies.

12 Employing about 19 million persons, public sector currently contributes about a quarter of India's measured domestic output. Administrative departments (including defense) account for about 2/5th of it, the rest comes from a few departmental enterprises (like railways and postal services), and a large number of varied non-departmental enterprises producing a range of goods and services. These include, close to 250 public sector enterprises (PSEs) owned and managed by the central government, mostly in industry and services (excluding the commercial banks and financial institutions). At the state level, production and distribution of electricity and provision of passenger road transport form the principal activities under public sector, run mostly by autonomous boards and statutory corporations. There are about 1,100 State Level Public Enterprises (SLPEs) that are relatively small in size.

- **Departmental undertakings:** Departmental undertakings are primarily meant to provide essential services such as railways. They function under the control of the respective ministries of Government of India (GoI). A departmental undertaking structure is considered suitable for activities the government aims to keep in its control in view of the public interest.
- **Statutory corporations:** Statutory corporations are public enterprises that came into existence by a Special Act of the Parliament. The Act defines the powers and functions, rules and regulations governing the employees and the relationship of the corporation with government departments.
- **Government-owned companies:** Government-owned or controlled companies refer to companies in which 51% or more of the paid up capital is held by the central or any state government (partly or wholly by both). It is registered under the Indian Companies Act and is fully governed by the provisions of this Act.
- **Autonomous bodies:** Autonomous bodies are set up whenever it is felt that certain functions need to be discharged outside the governmental set up with some amount of independence and flexibility without day-to-day interference from the governmental machinery. These bodies are set up by the concerned ministries or their departments and are funded through grants-in-aid, either fully or partially, depending on the extent which such institutes generate internal resources of their own. These grants are regulated by the Ministry of Finance (MoF) through their instructions. They are mostly registered as societies under the 'Societies Registration Act' and in certain cases they have been set up as statutory institutions under the provisions contained in various Acts.

The central public sector enterprises produce around 90 percent of India's coal, 65 percent of its refined oil, 83 percent of its natural gas, 32 percent of its finished steel, 35 percent of its aluminum, and 27 percent of its nitrogenous fertilizer. Indian Railways alone employs 1.6 million people, making it the world's largest commercial employer. Financial sector PSEs account for 75 percent of India's banking assets. In plain commercial terminology the equity in PSUs essentially belongs to the people or citizens. A number of PSEs serve critical functions of furthering the socio-economic objectives of the Government and ensuring stability in prices of key products and commodities.

Liberalisation and Reforms in Public Sector

With the economy embarking on the process of Liberalisation, Privatization and Globalisation, the role of PSUs has subsequently undergone a rapid change. Integration with world market has thrown up a plethora of opportunities and challenges.

Reforms during the 1990s focused on liberalization and deregulation of most sectors, disinvestment of government shares, greater autonomy through delegation of decision-making powers to leading companies, and the development of a performance monitoring system to ensure accountability.¹³

In 1997, the Indian government decided to strengthen the CPSEs to become global giants and thus planned to improve the autonomy and delegation of powers to a select group of CPSEs called “Navratnas” (known as Nine Jewels or profit making enterprises in Indian language) symbolizing nine profit making and largest public sector of India and subsequently, another category called “Miniratnas” (smaller jewels) The policy enunciated by the Department of Public Enterprises (DPE) made it obligatory for this select group of companies to restructure the boards to be able to exercise the enhanced autonomy and authority.

In the first instance, the CPSEs were required to induct at least four independent directors (termed as “non-official part time directors) with demonstrated experience and professional standing. It further advised that such members of the board should reach at least 1/3 of the total strength within six months. The selection of such independent directors was required to be done by a high-powered Search Committee comprising of the Chairman – Public Enterprises Selection Board, the Secretary – Department of Public Enterprises, the Secretary of the concerned administrative ministry and one or more eminent persons to be nominated by the Industry Minister. Thus, board restructuring became an important condition for greater autonomy and fostered improved corporate governance. Subsequently, all the listed CPSEs were required to meet Clause-49 of the listing agreement¹⁴ with the stock exchanges as directed by the SEBI, which has strict requirements

13 Khanna, Tarun and Krishna G. Palepu. “Globalization and Convergence In Corporate Governance: Evidence From Infosys and The Indian Software Industry,” *Journal of International Business Studies*, 2004, v35 (6, Nov), 485-507.

14 While some countries, including the UK and many Commonwealth countries, adopted what became known as a ‘principles-based’ or ‘comply or explain’ approach to the enforcement of the provisions of corporate governance codes, in US, provisions of Sarbanes Oxley and other statutes follow a rule based approach. In India, clause 49 is a hybrid approach, as those requirements which can be enforced are classified as mandatory and others, which are desirable, are classified as non-mandatory. The disclosures of the compliance with mandatory requirements and adoption (and compliance) / non-adoption of the non-mandatory requirements shall be made in the section on corporate governance in the Annual Report.

relating to independent directors, audit committees, reporting and disclosure standards.

Governance reforms gained prominence for several reasons: increased pressures on Central Public Sector Enterprises to improve further their competitiveness as a result of exposure to competition and hard budget constraints; listing of PSEs on the capital markets; and a slowdown in disinvestment. Underlying all of these factors is a desire to shift the government's role from a market player to a market regulator and to reorient it away from day-to-day management of CPSEs towards exercising its core ownership or shareholder rights based on sound corporate governance principles. Besides disinvestment of select Central PSUs has also gathered steam to meet the governments massive social spending and bridge the economy's growing fiscal deficit.

In short, over the decades, and especially since 1991, a number of initiatives have been undertaken to improve CPSE governance with a view to bringing about higher levels of PSE efficiency, investment, and economic growth. Prior to the adoption of Clause 49, India was considered a laggard in corporate governance. From independence in 1947 through 1991, India was essentially a socialist country. With the government controlling the economy and most key aspects of financing, there was little incentive for managers of private firms to adopt good governance practices. A fiscal crisis in 1991 led to a series of economic reforms and rapid economic growth. With government taking a smaller role, firms sought other sources of capital to finance expansion. That led to governance reforms in 1998 that were intended to ease investors' worries about putting money into Indian firms. But because these rules were voluntary, few firms adopted them. In 1999, India's securities regulator, the Securities and Exchange Board of India (SEBI), formed the Kumarmangalam Birla Committee to propose further reforms, and it came up with Clause 49, named for a clause to be added to stock-listing requirements.

In recent years reform has moved from the past focus on privatization and liberalization to include broader initiatives such as corporate governance and continued support for performance monitoring and restructuring, while maintaining a commitment to a prominent role for the state in the Indian economy as both owner and regulator of PSEs.

**Table 1: BRIEF HISTORY OF PUBLIC SECTOR REFORMS
IN INDIA SINCE LIBERALIZATION IN 1991**

Public Enterprise Reforms Process	Time Period	Key Reforms	Results
PHASE 1: <i>New Industrial Policy</i>	July 1991 – May 1996	• 'De-reservation' involving liberalisation of hitherto closed sectors dominated by state monopolies • 'Disinvestment' involving limited and partial sale of government shares • 'Memoranda of Understanding', a performance evaluation system, expanded • 'Sick' CPSEs referred to the Board for Industrial and Financial Reconstruction	• Number of state monopolies decreased from 17 to six within a couple of years • State raised Rs195bn between Dec 1991 to Nov 1995 through disinvestment • Failed to improve performance significantly and generated lukewarm response from private sector and general public
PHASE 2: <i>Empowerment of Enterprises</i>	June 1996 – March 1998	• Operational autonomy granted to very large CPSEs • Professionalisation* of the 'Board of Directors' in PSEs • 'Disinvestment Commission' set up • Dramatic reduction in state compliance guidelines and requirements	• 'Navaratna package' for 11 CPSEs and 'Miniratna package' for 97 PSEs created • Government abolished 695 guidelines governing CPSEs, retained 105 and modified 25
PHASE 3: <i>Open Privatisation</i>	April 1998 – May 2004	More open privatisation policies made apparent through: • The buy-back and cross holding of some shares • Down sizing, restructuring and professionalisation* of PSEs and governing boards • Shutting-down selected sick CPSEs	• Open mention of privatisation in government policy documents and budget papers • Indian government raises Rs51.90bn through the sales of shares of PSEs • Volunteer Retirement Scheme initiated in the first phase extended beyond sick enterprises to marginally profitable companies • Attempt to privatise Indian Airlines but shut down by presidential decree
PHASE 4	May 2004 – Present	• Cautious attitude to privatisation driven by political considerations including the government's dependence on communist parties for support • Corporate Guidelines for CPSEs introduced	• Restructuring and modernising sick companies • Devolving commercial autonomy to successful companies • Induction of the private sector in turning around sick companies • Less reliance on ownership changes and more on internal governance and management reform to improve performance

* A change in selection, operation to increase standards of process and decisions.

So, corporate governance was squarely on the top PSE reform agenda. Interest in corporate governance was driven by recognition of:

- > The important role that CPSEs continue to play in the Indian economy and the significant room for further improvements in performance;
- > The need to tackle the substantial governance challenges that still remain; and
- > The benefits of improved governance in terms of achieving higher levels of performance, greater access to capital markets, and increased transparency and accountability.

According to Jayanta Roy; President of Indian Chamber of Commerce (2010)“ Today, both the Public and Private sector have become an integral part of the economy, with both the sectors complimenting each other in strengthening the nation’s industrial landscape.”Being the largest commercial enterprises in the country, PSUs provide a huge leverage to the government (their controlling shareholder) to intervene in the economy directly or indirectly to achieve the desired socio-economic objectives.

At times, these objectives may be misplaced but at others especially in difficult economic times as in 2008, PSUs can play a significant role in steering the national economy in the right direction. For example, Life Insurance Corporation (LIC), one of the largest PSUs, was probably the only large investor in the Indian equity market when rest of the big investors preferred to stay away during the market turmoil. India is a welfare state and the social strata need to be looked into as well. Hence, the PSUs are be pegged to perform or they have to meet up with the fate of privatization.

According to Cassidy, R. (2009) the current crisis raises the fundamental question of governance and unfettered capitalism A hands-off (*laissez-faire*) policy is not adequate for markets to function. The government must guarantee consistent, fair laws and rules so that a market economy may emerge. Without rules and structures of a binding nature, it is inherently difficult to hold corporates accountable. Under such conditions business becomes nothing but ‘casino capitalism’ where investments are simply bets: bets that people will keep their word, bets that the firms are telling the truth, bets that employees will be paid, and bets that debts will be honoured. This speculative tendency puts the economy and corporates on overdrive making them reckless in their decisions; thereby flouting the rules and forgetting about risk management. (Cassidy, 2009)

The tradeoffs for public sector are increasingly important in the context of liberalization where government is expected to relinquish its control over a wide range of public sector activities. But it is not easy for the state to

simply give up control of the PE (especially in developing countries which are marred by huge inequalities). Here public sector have a major role as an apparatus of redistribution and vehicle of inclusive growth.. Indeed, given this institutional vacillation, there are economic reasons (in addition to political reasons) for government control.

Recent events suggest that many public enterprises are doing well and are contributing to the market capitalization. They have become important players in the markets for mining, oil, gas, earthmoving, steel, banking, engineering, and heavy electrical competing with Fortune 500 MNCs. Successful and profit making. Public enterprises have been promised “full managerial and commercial autonomy” operating in a competitive economy. The key was to restructure relations between the government and PEs so that the PEs enjoys the desired autonomy and accountability and remain free from political interference.

Public sector undertakings (PSUs) in India have weathered the economic slowdown better than their private sector counterparts, a study by business information provider Dun & Bradstreet (D&B) India has revealed. During FY11, out of the total 220 operating CPSEs, a majority of 158 CPSEs (70%) were profit making and 62 CPSEs incurred losses. The number of profit making CPSEs increased from 154 in FY07 to 158 in FY11. The profit of these profit making CPSEs increased from R 895.8 bn in FY07 to R 1,137.7 bn in FY11, registering a CAGR of 6.2% during this period. This was led by robust performance by mining companies, electricity/power companies and selected oil & gas companies. The turnover of the CPSEs has been growing at 11.2% CAGR during FY07 to FY11. (Dun & Bradstreet Survey; 2012)

In view of the significant contribution of the public sector and the dominant role it would continue to play in the Indian economy, improving governance in PSEs has assumed a sense of urgency. Considering the values at stake, it is only reasonable that governments develop their expertise as owners and improve the governance of their enterprises. But while the gains are apparent, practicing corporate governance of state owned enterprises is a complex task. One paramount challenge is to find the right balance between the government’s duty to be an active owner, while desisting from making undue political interference in the management of the company. Another challenge is to make sure that the government does not distort competition in the way it uses its regulatory and supervisory powers (Isaksson, 2005). Drawing from the public sector experience of other developed economies such as Sweden it is essential that the CPSEs

in India clarify their objectives and secure an explicit mandate from the general public. For instance, in Sweden, the National Rail Operator was told to match industry standards for returns on equity (13 percent), interest coverage (2:1), and minimum debt-to-equity ratios (1:1). Transparency of this nature helps create accountability which can put a positive pressure on CPSEs to perform.

By releasing the voluntary guidelines on corporate governance, the government has expressed a strong desire to improve the corporate governance standards in Corporate India. The most significant aspect of the guidelines is that they are applicable to both listed as well as un-listed Central Public Sector Enterprises (CPSEs). The DPE guidelines are mostly in line with the Clause-49 of the listing agreement with stock exchanges issued by the Securities and Exchange Board of India (SEBI). The guidelines also carry a model code of business conduct and ethics for board members. The Memorandum enclosing the guidelines states *“These guidelines though voluntary in nature should be followed by all CPSEs as proper implementation of these guidelines would protect the interests of shareholders and relevant stakeholders. The compliance with these guidelines requires to be reflected in the Directors’ report, Annual Report and Chairman’s speech in the Annual General Meeting. This Department would also grade the CPSEs on the basis of their compliance of the corporate governance guidelines”*. It is expected that the DPE will allow sufficient time for the CPSEs to conform to these guidelines and undertake appropriate studies for assessment and grading of the CPSEs, in the course of time.

The guidelines cover issues such as the composition of the boards of directors, the role and power of the audit committee, required disclosure, as well as details on how to implement these guidelines. Important features include the fact that risk management is clearly put under the board’s responsibility. The guidelines also have an annex of *“Model Code of Business Conduct and Ethics for Board Members and Senior Management”*. They include a whole chapter on disclosure, with the requirements to have a separate section in the annual report on corporate governance with details on compliance with these guidelines.

The SOEs are required to also get a certificate from either their auditors or the company secretary on compliance with these Guidelines. The DPE also decided to grade CPSEs based on their implementation of these guidelines.

There is an explicit recommendation in these guidelines for all unlisted companies to progressively move towards meeting the guidelines and list on the stock exchanges. The Prime Minister, Dr. Manmohan Singh, said in

his address to the Conference of Chief Executives of CPSEs in March 2007 that *“it may be useful for more public enterprises to be listed on the Stock Exchange, as this would enhance professionalization of the Board of Directors and empower Independent Directors. Induction of Independent Directors on the Board of PSEs would, I believe, ensure greater efficiency and effectiveness in decision making processes as well”*.

Further, the Finance Minister stated in June 2007 on the occasion of releasing these comprehensive guidelines that *“The ultimate unlocking of value for PSEs is only by listing in a Stock Exchange. That does not make it any lesser a public enterprise or dilute the character of PSE there is need to reassess the role of Public Sector in a growing global market. The market is the world, not just India. Fundamental to success of any corporate set up is to achieve global benchmarks”*.

As the government’s disinvestment strategy gathers momentum, there is a genuine need to improve the levels of transparency, and accountability within PSUs. However, there continues to be concerns around effective implementation of these norms. Autonomy of PSUs, functioning of the PSU boards, failure on the part of many listed PSUs (Navratnas and Miniratnas) to comply with Clause 49 of the Securities and Exchange Board of India SEBI Listing Agreement and the vast differences that exist between the governance standards prevalent in central and state PSUs are some of the key issues that need to be tackled on a war footing.

The Agency Problem of Corporate Governance:

In the evolution of modern capitalism, with separation of ownership from control as firms grow in size and complexity, agency problem arises: how to ensure that the managers (“promoter” in Indian parlance) work to maximise return on shareholders’ capital. Given the information asymmetry, managers could pursue their private goal disregarding the shareholders’ interests.

This is at the heart of the problem of modern literature on corporate governance. Various institutional and contractual mechanisms have evolved in the last century to grapple with this problem.

In the context of efficiency of resource use in a socialist or mixed economy, Oskar Lange (1936) sought to solve the problem of how to ensure that managers of public firms’ maximized efficiency consistent with the goals set by the central planners.¹⁵ However, looking at the microeconomics of firms in a socialist economy, Jonas Kornai argued that they were unlikely

¹⁵ Oskar Lange ‘On the Economic Theory of Socialism’ Review of Economic Studies 4 (October 1936): 53-71.

to be efficient because of the soft budget constraint¹⁶: that is, firms do not go bankrupt or managers do not lose their jobs for their poor performance. Firms can always renegotiate their contracts with the planners to hide their inefficiency.

In India public sector firms are often faced with multiple objectives, and multiple owners or monitors – central government, state governments, legislators, public auditors and so on.

Managers may not necessarily maximise profits as they could always highlight a particular achievement to suit their convenience. Managers may be risk averse as they face constitutionally mandated procedural audit by the CAG if an enterprise is majority government owned. Managers' efficiency objectives may come in conflict with dysfunctional political interference in operational matters (at the expense of policy issues) to meet narrow political goals. However, at the same time, poor performance by managers does not involve any punishment as they can re-negotiate the output prices, budgetary support, or have access to soft and/or government guaranteed loans; in other words they do not face a hard budget constraint.

Since it is often not possible for a principal to identify in advance the agent who may be susceptible to the agency problem, corporations generally rely on material incentives and impose monitoring mechanisms to better align the interest of the principals and agents.

Failure of the corporate internal control system results in 'waste of free cash flows'. This happens typically because:

- a) Managers resort to 'power-seeking' activities rather than 'value-seeking' activities. They invest for revenue growth and unwarranted diversification.
- b) Managers fail to visualize early the excess capacity in the industry resulting from decline in demand, technological changes, and globalisation.
- c) Managers expropriate shareholders' wealth. They indulge in self-dealing. They benefit themselves with perquisites disproportionate to the firm performance and industry norms. They take decisions to improve the performance of the firm in the short term ignoring the detrimental effect of those decisions on the long-term health of the firm.

¹⁶ The term 'soft budget constraint (SBC)', has become a familiar part of the economics lexicon. Originally formulated by Kornai (1979, 1980 and 1986) to illuminate economic behaviour in socialist economies marked by shortage, the concept of SBC is now regularly invoked in the literature on economic transition from socialism to capitalism. Indeed, SBC problems currently constitute a central policy issue in transition economies. But the concept is increasingly acknowledged to be pertinent well beyond the realm of socialist and transition economies. A host of capitalist phenomena, such as the collapse of the banking sector of East Asian economies in the 1990s, can be usefully thought of in SBC terms. <http://emlab.berkeley.edu/~groland/pubs/understanding.pdf>

- d) Managers fail to provide the right organization culture and supporting environment.
- e) Managers shirk responsibilities.
- f) Managers entrench control in spite of poor performance

Thus, the agency problem is endemic to all economic systems. Moreover, problem of soft budget constraint is not restricted to socialist economies but evident in market economies as well when the firm is question is large and considered of strategic importance for the economy, though perhaps to much lesser extent. Rescue of Chrysler Corporation – the third largest automotive firm in the US – in the late 1970s and United Airlines after “9/11” in the US or more recently most notably Northern Rock in September 2007 and Bearn Stearns in March 2008, reaching a critical peak after the failure of Lehman Brothers on 15 September 2008 are clear instances of state support for failing companies. Such support is more common in financial sector, where failure of firms can have significant systemic risk.

Good Governance Framework for Public Sector

Public sector governance covers the set of responsibilities and practices, policies and procedures, exercised by an agency’s executive, to provide strategic direction, ensure objectives are achieved, manage risks and use resources responsibly and with accountability. It also encompasses the important role of leadership in ensuring that sound governance practices are instilled throughout the organization and the wider responsibility of all public servants to apply governance practices and procedures in their day-to-day work.

Good governance is about both: **performance** – how an agency uses governance arrangements to contribute to its overall performance and the delivery of goods, services or programmes, and conformance – how an agency uses governance arrangements to ensure it meets the requirements of the law, regulations, published standards and community expectations of probity, accountability and openness.

The governance framework is based on principles of public sector governance including:

- **accountability** – being answerable for decisions and having meaningful mechanisms in place to ensure the agency adheres to all applicable standards
- **transparency/openness** – having clear roles and responsibilities and clear procedures for making decisions and exercising power

- **integrity** – acting impartially, ethically and in the interests of the agency, and not misusing information acquired through a position of trust
- **stewardship** – using every opportunity to enhance the value of the public assets and institutions that have been entrusted to care
- **efficiency** – ensuring the best use of resources to further the aims of the organization, with a commitment to evidence-based strategies for improvement
- **leadership** – achieving an agency-wide commitment to good governance through leadership from the top.

Corporate Governance can be simply defined as a set of systems, processes and principles which ensure that a company is governed in the best interest of all stakeholders. These principles can be used by a nation state to design its own corporate governance rules. Auditors may use them to assess the adequacy of any corporate governance regime in the absence of more immediate standards. (OECD; 2005)

It is about promoting corporate fairness, transparency and accountability. In other words, ‘good corporate governance’ is simply ‘good business’.

It ensures:

- Adequate disclosures and effective decision making to achieve corporate objectives;
- Transparency in business transactions;
- Statutory and legal compliances;
- Protection of shareholder interests;
- Commitment to values and ethical conduct of business.

Overarching Principles of Corporate Governance in India

The growing reach of regulations, aspirational best practices and growing demands of stakeholders is contributing to the continued evolution of the subject of corporate governance worldwide. Corporate events coupled with dynamic shifts in the economic and business cycles are leading to newer and innovative regulatory responses, theories and facets. Not only this, they are also leading to an increase in the domain of what constitutes governance in current times. Different countries, jurisdictions, companies and practices are contributing to this overall advancement.

- > While some countries, including the UK and many Commonwealth countries, adopted what became known as a ‘principles-based’ or ‘comply or explain’ approach to the enforcement of the provisions of corporate governance codes, in US, provisions of Sarbanes Oxley

and other statutes follow a rule based approach. In India, clause 49 is a hybrid approach, as those requirements which can be enforced are classified as mandatory and others, which are desirable, are classified as non-mandatory. The disclosures of the compliance with mandatory requirements and adoption (and compliance) / non-adoption of the non-mandatory requirements shall be made in the section on corporate governance in the Annual Report.

- > It is felt that rule based approach alone may not serve the purpose of improving the Corporate Governance of listed companies. A hybrid approach, wherein the broad principles are laid down to give broad direction to the companies on Corporate Governance and what is expected of them followed by rules to mandate compliance with specific aspects of Corporate Governance would be considered as the most effective mechanism for improving Corporate Governance in the Indian scenario.

Our country's current corporate governance framework has been the result of a numerous efforts, both regulatory and industry-driven. Incidentally, country's first ever corporate governance code was developed by CII for voluntary adoption by listed companies in 1998. This is a unique instance where an industry association took the lead in recommending corporate governance practices. Many of its recommendations were subsequently incorporated in the report of the Kumar Mangalam Birla Committee (1999) set up by SEBI and were subsequently incorporated under Clause 49 of the Listing Agreement. SEBI's Narayana Murthy Committee (2003) reviewed Clause 49 and suggested further measures to improve corporate governance standards.¹⁷ In 2004, the MCA established the National Foundation for Corporate Governance (NFCG) in partnership with Confederation of Indian Industry (CII), Institute of Company Secretaries of India (ICSI) and Institute of Chartered Accountants of India (ICAI).¹⁸ Corresponding to these developments, the Ministry of Corporate Affairs has also proposed an overhaul of the existing Companies Act, 1956 and introduced governance reforms through the proposed company law viz. the Companies Bill, 2012. These have largely been based on the recommendations of the Expert Committee on Company Law under the chairmanship of Dr J J Irani (2005) and the Voluntary Guidelines on Corporate Governance 2009. (MCA; 2012)

17 The Securities and Exchange Board of India (Amendment) Act, 2002, amended the Securities and Exchanges Board of India Act, 1992 and enlarged its Board of Directors, besides conferring on SEBI the powers of search and seizure, with the approval of courts, and enhancing the fine for a better and hassle-free regulation of the capital market. The Act is also aimed at avoiding recurrence of scams and other malpractices in the capital market by building confidence among investors.

18 See National Foundation for Corporate Governance, About Us, <http://www.nfcgindia.org/aboutus.htm>

Corporate Governance Framework for Indian Central Public Sector Enterprises (CPSEs)

CPSEs generally fall under the same legal framework as the private sector, although some laws contain special provisions or exemptions for state-owned companies. They are mainly governed by the Companies Act, Clause 49 of the Listing Agreement, and various DPE guidelines issued over the years. In addition CPSEs are subject to various other laws and regulations.

The main laws include:

COMPANIES ACT 1956 (CA): CPSEs and other companies in which the government, directly or indirectly, holds 51 percent or more of the paid-up share capital are incorporated under section 617 of the CA as “government companies”. Their governance form and structure are prescribed by the Act and the companies’ articles of association. The principal difference between private firms and CPSEs is that in the latter the auditor is appointed by the Comptroller and Auditor General (CAG) instead of the government as shareholder. All other processes are more or less the same except for mergers and amalgamations of CPSEs where the same procedures are followed but where the power of the High Court is exercised by the government.

COMPANIES BILL, 2012: The Companies Bill, 2012 passed by the Lok Sabha (Lower house of Indian Parliament) on December 18, 2012 has proposed certain salutary provisions to push the frontiers of corporate governance. The new Companies Bill, 2012 proposes structural and fundamental changes in the way companies would be governed in India and incorporates various lessons that have been learnt from the corporate scams of the recent years that highlighted the role and importance of good governance in organizations.

Some of those new provisions are:

- > Requirement to constitute Remuneration and nomination committee and Stakeholders Grievances Committee
- > Granting of more powers to Audit Committee
- > Specific clause pertaining to duties of directors
- > Mode of appointment of Independent Directors and their tenure
- > Code of Conduct for Independent Directors
- > Rotation of Auditors and restriction on Auditor’s for providing non-audit services
- > Enhancement of liability of Auditors
- > Disclosure and approval of RPTs
- > Mandatory Auditing Standards

- > Enabling Shareholders Associations/Group of Shareholders for taking class action suits and reimbursement of the expenses out of Investor Education and Protection Fund
- > Constitution of National Financial Reporting Authority, an independent body to take action against the Auditors in case of professional mis-conduct
- > Requirement to spend on CSR activities

SECURITIES REGULATION/CLAUSE 49 OF THE LISTING AGREEMENT:

Listed CPSEs fall under securities regulation and the listing agreement issued by the Securities and Exchange Board of India (SEBI). This includes basic disclosure requirements and Clause 49, which contains important corporate governance norms. Introduced in 2000 and revised in 2003-04, Clause 49 has both mandatory and voluntary provisions. Mandatory provisions relate to board composition, audit committees, board procedures, management discussion and analysis in the annual reports, certification of financial statements and internal controls, and corporate governance reporting.

DEPARTMENT OF PUBLIC ENTERPRISE (DPE) GUIDELINES: In addition to the 1997 Circular on delegation of powers, DPE guidelines determine many of the practices and procedures of CPSEs, including those related to finance, human resource development, operation of CPSEs, functioning of boards of directors, and the performance monitoring system. Hundreds of such guidelines have been issued over the years. In the mid to late-1990s, with a view to streamlining, GOI abolished nearly 700 guidelines, while retaining 105 and modifying another 25. Some guidelines are binding, while others are voluntary.

GUIDELINES ON CORPORATE GOVERNANCE FOR STATE-OWNED ENTERPRISES (CG GUIDELINES): Issued by DPE in 2007, these guidelines are voluntary and are applicable to all CPSEs (it is not clear whether and how statutory corporations can adopt them given their special legal form). The main focus of the CG Guidelines is on the board of directors and audit committees but they also touch on disclosure and subsidiary companies. Important provisions include: (i) issuance of a formal appointment letter to directors; (ii) Separation of the office of chairman and the CEO; (iii) institution of a nomination committee for selection of directors; (iv) limiting the number of companies in which an individual can become a director; (v) tenure of directors; (vi) remuneration of directors; (vii) training of directors; (viii) performance evaluation of directors; and (ix) additional provisions for statutory auditors. While the CG Guidelines are

voluntary, CPSEs are expected to note their compliance and explain areas of non-compliance (comply or explain).¹⁹

Other laws and regulations: Various other laws and regulations impinge on CPSE governance. Main among these are:

RIGHT TO INFORMATION (RTI) ACT 2005: RTI is a landmark initiative for enhancing transparency and governance of the public sector as a whole. The Act requires that various CPSE reports and statements be made available to the public. In practice, many CPSEs have established websites linked to that of their administrative ministry to meet the law's requirements. Documents that are not regularly disclosed to the public may also be demanded from CPSEs.

LABOUR LAWS: Most of the Acts related to employee relations and protection apply to CPSEs, though there are some special provisions and exemptions. The Factories Act 1948, Apprentices Act 1961, Equal Remuneration Act 1976, Industrial Disputes Act 1947, and the Industrial Employment (Standing Orders) Act 1946 all contain special provisions for PSEs. Supreme Court decisions govern employee relations, giving CPSE employees the formal status of GOI employees, but more recently denying that they had full civil service status.

INSOLVENCY LAWS: CPSEs fall under the same insolvency and liquidation laws as other companies, including: the Sick Industrial Companies Act which governs restructuring for all industrial companies (public and private); the CA which covers liquidation; and the general civil procedure law which contains provisions for the appointment of receivers.

OTHER ACTS AND REGULATIONS: The Competition Act 2002 applies to CPSEs, but exempts those carrying out sovereign functions or activities necessary for the discharge of these functions. CPSEs are also subject to other laws and regulations, such as sector regulation and environmental law. (World Bank; 2010)

Institutional Framework for CPSEs

Institutional arrangements for exercising the state's ownership rights are many-sided compared to international practice. GOI shareholding in CPSEs is held by the President of India, ex-officio. His powers as a shareholder are delegated to 38 administrative ministries, each with its own portfolio of CPSEs. DPE serves as the nodal agency. In addition,

¹⁹ See Umakanth Varottil., Voluntary Nature of Corporate Governance Norms (Mar, 9, 2010), <http://indiacorplaw.blogspot.com/2010/03/voluntary-nature-of-corporate.html>.

a number of other governmental bodies have oversight, regulatory, and recommendatory roles.

The specific roles of the major bodies are as follows:

Administrative ministries: As delegated owners, administrative ministries represent GOI in the AGM, participate in board selection, approve major decisions, monitor performance, and restructure sick or loss-making units. They consult other ministries and departments on various matters and obtain Cabinet approval as needed.

DPE: Located in the Ministry of Heavy Industries and Public Enterprises, DPE is the nodal agency for all CPSEs. DPE has five divisions – financial policy, management policy, MOU division, administration and coordination, and the permanent machinery of arbitration (PMA) DPE sets policies and guidelines for CPSEs and acts as an interface between administrative ministries and CPSEs. It also manages the MOU system, supports the board appointment process, conducts an annual survey of CPSEs, and provides reports to parliament and the public.

Cabinet: The Cabinet approves a range of major decisions through the High-Powered Committee chaired by the Prime Minister, and finalizes the choice of CPSE board directors through the Appointment Committee of Cabinet (ACC).

Ministry of Finance (MOF): It reviews many CPSE finance and investment decisions, as does the Public Investment Board (PIB) for investment plans over Rs. 100 crores (US\$2.3 million).

Oversight and Control Bodies for CPSEs:

CPSEs are accountable to a number of different bodies, including:

Parliament: As the main oversight body, a number of parliamentary committees routinely review CPSE performance and related issues.

Comptroller and Auditor General (CAG): CPSEs with more than 50 percent of ownership are subject to CAG oversight. An independent body established by the Constitution of India, CAG: (i) appoints the statutory auditor and oversees and supplements their work; (ii) conducts regular transaction audits of CPSEs; (iii) conducts performance audits of CPSEs that focus on particular topics and sectors; and (iv) reports the findings to parliament.

Central Vigilance Commission (CVC): CVC has a mandate to deter corruption and malpractice in CPSEs through observance of procurement matters and clearance for all board positions.

Judiciary: CPSEs are subject to judicial review by the Supreme Court of India and the High Courts.

Regulatory bodies: These bodies oversee CPSEs in much the same way they oversee private sector companies. They include: (i) SEBI, which enforces securities rules for listed CPSEs; (ii) Ministry of Company Affairs (MCA), which oversees compliance with the Companies Act; and (iii) sector regulators, like the Telecom Regulatory Authority, which regulate pricing and other sector specific issues for relevant CPSEs.

Recommendatory bodies: These include: (i) the Public Enterprises Selection Board (PESB), which manages the process for selecting board members, including tenders and advertising, interview panels, and preparation of short-lists. The PESB is overseen by an independent board and supported by the Ministry of Personnel. ACC approves the final selection; (ii) Board for Reconstruction of Public Sector Enterprises (BRPSE), which was set up in 2004 as an independent body that advises the government on the restructuring and revival of poorly performing CPSEs; and (iii) Standing Conference of Public Enterprises (SCOPE), a membership body for CPSEs and other state companies. It acts as an interface between GOI and CPSEs, and organizes conferences and training, including on corporate governance, for its members. (World Bank; 2010)

Key Forces Driving Corporate Governance Reform

Of late, a burgeoning empirical literature has documented important features of corporate governance in India. Most of the corporate governance problems noted, far from being unique to India, are in fact commonplace in many emerging Asian economies. In particular, corporate governance in India does not compare unfavourably with any of the other major emerging economies like: Brazil, China and Russia. (White Paper on Corporate Governance in Asia; 2003) In order to reach the appropriate audience and to properly deal with the policy challenges ahead, the Network on Corporate Governance of State-Owned Enterprises in Asia (the “Asian SOE Network” 2005) brings together experience and expertise from most Asian economies. The Asian SOE Network has met regularly since its founding. The objectives of the Network are to raise awareness of all concerned constituencies about the importance and challenges related to the good corporate governance of SOEs and to evaluate the current SOE corporate governance policy frameworks and practices, benchmarking these against international good practice as reflected by the OECD Guidelines.

The corporate governance landscape in the country has been changing rapidly over the past two decade, particularly since the enactment of Sarbanes-Oxley type measures in Clause 49 of the Listing Agreements, of SEBI and legal changes to improve the enforceability of creditor's rights. The Securities and Exchanges Board of India has put in place a rigorous regulatory regime to ensure fairness, transparency and good practice, and the National Stock Exchange of India also functions efficiently and transparently to now trade among the highest number of trades in the world, just behind NASDAQ and NYSE . The traditional Bombay Stock Exchange has also reformed effectively. All these positive developments have arguably helped Indian industry ensure that their financial gains reach their investors fairly and transparently, and enabled it to sustain its new-found prosperity and growth²⁰ (Chakrabarti. R; 2007)

With regard to public sector governance, Nandini Gupta (2005) finds that even when control stays in government hands, partial privatization has a positive impact on profitability, productivity, and investment of the PSEs concerned.²¹ She argues that the monitoring role of the markets has been responsible for this. However, S. Sangeetha (2006) argues that it may be difficult to disentangle the effect of partial privatizations from the effect of the application of MoUs to these cases before the partial privatizations. She finds that the application of MoUs or performance contracts had a positive impact on the profitability and the operational performance of PSEs.²² According to KPMG report on Corporate Governance in Public Sector 2010 the autonomy of PSUs, functioning of the PSU boards, failure on the part of many listed PSUs (Navratnas and Miniratnas) to comply with Clause 49 of the SEBI Listing Agreement and the vast differences that exist between the governance standards prevalent in central and state PSUs are some of the key issues that need to be tackled on a war footing.²³ Good corporate governance, complemented by a sound business environment, can strengthen private investment, corporate performance, and economic growth.

20 Corporate governance in India does not compare unfavourably with any of the other major emerging economies: Brazil, China and Russia. India ranks high on the ease of getting credit, and has a well-functioning banking sector with one of the lowest proportions of nonperforming assets. The two main Stock Exchanges have among the highest number of trades in the world, and the relatively young *Securities and Exchanges Board of India* has a rigorous regulatory regime to ensure fairness, transparency and good practice. Most importantly, the corporate governance landscape in the country has been changing fast over the past decade, particularly with the enactment of Sarbanes-Oxley type measures and legal changes to improve the enforceability of creditor's rights. If this trend is maintained, India should have the quality of corporate governance necessary to sustain its impressive current growth rates.

21 Nandini Gupta, 2005, "Partial Privatization and Firm performance," *Journal of Finance* 60, pp. 987-1015.

22 S. Sangeetha, 2006, *Empirical Essays on Enterprise and Ownership Reforms in Public Sector Enterprises - Evidence from India*, Draft Ph.D. dissertation, IGIDR

23 KPMG; Corporate Governance in Public Sector- A road ahead; 2010

The State and the State Controlled Enterprises: Need to Re-establish Relationship

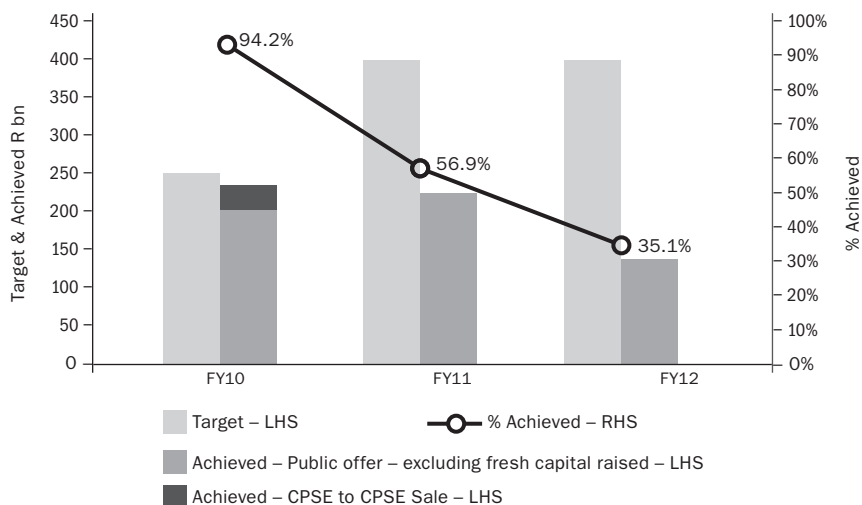
The lacuna in Indian corporate governance is arguably not what is missing in the letter of the law, but what is missing in the internalisation and implementation of it. The mandatory provisions of the law (be it the provisions of the listing agreement (as applicable to listed companies), or the proposed provisions of the Companies Bill, 2012) as they exist today and as are proposed to be supplemented are not far from the global standard – in fact the broad features of Indian corporate governance norms have been transplanted from other jurisdictions such as the USA and the UK.²⁴ Possibly, a part of the problem with implementation of corporate governance in India has been the fact that rules have simply been transplanted from other jurisdictions rather than emerged organically. We need to understand what makes the Indian scenario distinct so as to forge some practical suggestions on how to strengthen the actual performance of Indian corporate governance within the existing legal framework.

In the context of Public Sector, how the state organizes and exercises its ownership rights is central to improving CPSE governance.²⁵ There has been a universal belief post liberalization that the government must restructure its activities and create market-related incentives and discipline for the enterprises in its control to compete in globalised market. Thus, corporatisation of state undertakings and privatisation has emerged as the most vital methods of improving the efficiency of both the State and the corporate entities. Consequently, governments have been announcing the disinvestment /sale of several companies, reducing their stake in the existing public enterprises, changing management tools and restructuring government departments to become competitive companies in the market. The disinvestment process is carried out in various ways including strategic sale to private entities, public offer through an IPO or FPO and auction to private entities among others. The annual targeted disinvestment of CPSEs, compared with its achievement over a three-year period, is shown in *Figure 1*:

24 Varma, Jayanth Rama, (1997), "Corporate Governance in India: Disciplining the Dominant Shareholder", *IIMB Management Review*, December 1997, 9(4), 5-18; Available at: <<http://www.iimahd.ernet.in/~jrvarma/papers/iimbr9-4.pdf>>

25 Afsharipour, Afra, A Brief Overview of Corporate Governance Reforms in India

(December 2010), Available at: www.conferenceboard.org, for an overview and assessment of the effectiveness of corporate governance reforms in India.

Figure 1: **DISINVESTMENT: TARGET V/S ACHIEVEMENT**

Sourced: BSE-PSU. Note: *Achieved – Excludes other receipts of the government from CPSE disinvestment

As seen from the above *Figure 1*, the actual achievement of disinvestment receipts has always fallen short of the targeted receipts during the three-year period of FY10-FY12. The targeted disinvestment receipt amount remained the same during both FY11 and FY12 at R 400 bn. However, actual receipts of disinvestments stood at R 140.4 bn in FY12 compared with R 227.6 bn in FY11, marking a 38% decline compared with its previous year. Thus, the percentage of disinvestment target actually achieved went down from nearly 57% in FY11 to 35% in FY12. This slowdown in the PSU disinvestment can be attributed to the recurrence of an uncertain global economic situation, primarily due to the fallout of the euro-zone crisis. (Dun & Bradstreet Survey; 2012)

All the CPSEs which divested in FY11 and FY12 chose the public offering route. In FY10, more than 90% of the disinvestment was carried out through the former stated means and rest was through CPSE-to-CPSE sales means. It is to be noted that, there was no disinvestment transaction during FY09, led by the impact of global financial crisis. During FY13, as per the union budget announcement the planned outlay for PSU through disinvestment is proposed to be at R 300 bn. Dun & Bradstreet Survey; 2012)

The Cabinet Committee on Economic Affairs (CCEA), gave the go-ahead to equity stake sale in four PSUs, namely, Hindustan Copper, Oil India Ltd.,

MMTC and Nalco, which is likely to mop up nearly Rs.15,000-crore or about 50 per cent of the Rs.30,000-crore divestment target set for 2012-13.

Further, international bodies have been advising / pressurising governments to gradually eliminate subsidies remove administered price mechanisms and reduce such other controls/support which contributes to false/artificial pricing and costs. The alternative, it is asserted, would perpetuate the moral hazard for the government, inefficiency in operations and management and the weak monitoring system.²⁶

The main challenge lies in making a complex and control oriented ownership framework more effective in striking the right balance between CPSE autonomy and accountability. This can be achieved by: (i) reforming ownership arrangements with a view to focusing the role of administrative ministries on policy-making and limiting their day-to-day role in commercial decision-making, giving boards greater decision-making powers in practice, and considering moving to a more centralized ownership model in the longer-term; (ii) improving the ways in which Government of India(GOI) exercises its key ownership functions, in particular enhancing transparency in the board appointment process and improving performance monitoring; (iii) enhancing the role and capacity of the Department of Public Enterprises as a nodal agency to make it a more active promoter of the governance agenda; and (iv) improving the Corporate Governance Guidelines so that they become a more effective governance tool. (World Bank; 2010)

The framework for the principles of corporate governance has emanated from the policy objective of creating efficient and transparent markets. Economic theory recommends privatization as a tool to improve the efficiency of state owned enterprises (SOEs) and provide incentives to restructure them (Kay and Thompson, 1986), but the designers of privatization could have different objectives. Understandably, codes and principles in different countries have tended to be based on a belief that all enterprises will be of one variety only despite the caution that “one size doesn’t fit all”. Thus, public enterprises have been treated in the same manner as the private either with the assumption that what is good for one is good for the other, or on the premise that eventually all enterprises should be free of dominant ownership of the government. However, despite the idealism and merit of free market economy, with appropriate incentive and disincentive mechanisms, there is a prospect

²⁶ Gupta, Arindam and Parua, Anupam, An Enquiry into Compliance of Corporate Governance Codes By the Private Sector Indian Companies (18 December 2006). Tenth Indian Institute of Capital Markets Conference Paper. Available at <SSRN: <http://ssrn.com/abstract=962001> >

of continued presence of public enterprises in India. For example, policy makers may be concerned about the employment levels ;controlling the prices of goods or retaining strategic control etc in the firm as opposed to efficiency, especially if they share the belief that privatization could engender layoffs. The Third Way between the unfashionable socialism and the romantic market fundamentalism rests on such a prospect.²⁷ (Giddens 1998)

The infirmities in governance architecture in the case of public enterprises appear to arise mainly from: the current powers to create, develop, renew and restructure the governing board and its members and their variance with the typical widely held public corporation. The powers specially created or exercised by the government, which are not in consonance with the transparency ideal and other generally accepted principles of good corporate governance.

Furthermore, in PSEs, members of the board and the Chairman are usually appointed by the concerned ministry and very often PSUs are led by bureaucrats rather than professional managers. Several strategic decisions are taken at a ministerial level which may include political considerations of business decisions as well. (The recent case were government had to draw flank from opposition for minimal increasing the prices of oil as the PSU oil companies were running in massive losses is an example of how the dominant shareholder, the Indian Government, uses its dominance to force decisions that are not always linked to business interests and may have political considerations.) Therefore, PSU boards can rarely act in the manner of an empowered board as envisaged in corporate governance codes. This makes several provisions of corporate governance codes merely a compliance exercise. A close examination reveals that good corporate governance in public enterprises implies attention to issues larger than those of law and stock exchanges.

Corporate Governance reforms in India have evolved a wide range of institutional and corporate initiatives that broadly include a) improving the functioning of capital markets, b) ensuring more effective protection of minority investors through promoting greater transparency of operations and higher standards of information disclosure, c) reforming company

²⁷ The “third way” was self-consciously associated with the invention of the term the “New Democrats” in the US – and later with “New Labour” in Britain under the leadership of Tony Blair. “The aim of Third Way thinking – revisionist social-democracy – is to create policies for the centre-left which respond to these (social and economic changes”. It was NOT a succumbing to neo-liberalism or market fundamentalism. On the contrary, it argued that social democrats had to move beyond two failed, or compromised, philosophies of the past, one being neo-liberalism, the other being “old-style social democracy,” characterised by a top-down state ownership of the “commanding heights of the economy” and Keynesian national demand management.

board's accountable to the shareholders d) reforming governance mechanisms of financial institutions.²⁸

The corporate governance initiative have come from a) the government through government legislations involving several amendments to the Companies Act 1956 and the enactment of Companies Bill Act 2012; b) the organizations, regulating capital markets, especially Securities and Exchange Board of India (SEBI) in the form of statutory regulations'; c) through self discipline and voluntary initiatives taken by the industry, chamber of commerce and business associations, professional bodies and company themselves. Various Committees have been formed by the government of India, SEBI and industry associations and their recommendations for implementation of corporate governance norms in India to which corporate houses have been submitted during the period 1998 to 2009.²⁹

SEBI regulatory initiatives have made an impact on nearly every aspect of the market. Some of those initiatives have transformed the market fundamentally. Particularly noteworthy is the growth in the following:

- Market capitalization;
- Number of listed firms;
- Trading volumes and turnover both in the spot and futures markets.

India has one of the most sophisticated new equity issuance markets. Disclosure requirements and the accounting policies followed by listed companies for producing financial information are comparable to the best regimes in the world.

The four important roles played by the government in an economy briefly are: a) the regulatory role b) the promotional role c) the entrepreneurial role d) the planning role.

²⁸ Chakrabarti, Rajesh; Yadav, Pradeep K. and Megginson, William L., "Corporate Governance in India", Journal of Applied Corporate Finance, Forthcoming, Available at SSRN: <http://ssrn.com/abstract=1012222>

²⁹ Report of the SEBI Committee on Corporate Governance; February 8, 2003

Government Role: Policy Guidance, Not Dominance

Necessarily, public sector enterprises have to work under the aegis of government, their major shareholder. The key question is whether under the changed economic context, they can continue to function under bureaucratic style systems, which include multiple controls exercised by various government agencies, in order to deliver commercial results that are expected of them.³⁰ The current “backseat driving” by Indian bureaucrats and politicians, in a context has to end. OECD suggests that: The state should act as an informed and active owner and lay down a clear and consistent ownership policy, ensuring that the governance of state-owned enterprises is executed in a transparent and accountable manner, with the necessary degree of professionalism and effectiveness (Isaksson, 2005).

Arguably, government as major shareholder has rights which cannot be denied. But the state as an active owner should exercise its ownership rights according to the legal structure of each company. Its prime responsibilities, according to OECD, include

- Being represented at the general shareholders meetings and voting the state shares;
- Establishing well structured and transparent board nomination processes in fully or majority owned PEs, and actively participating in the nomination of all PEs’ boards;
- Setting up reporting systems allowing regular monitoring and assessment of PE performance;
- When permitted by the legal system and the state’s level of ownership, maintaining continuous dialogue with external auditors and specific state control organs; and
- Ensuring that remuneration schemes for SOE board members foster the long-term interest of the company and can attract and motivate qualified professionals (Isaksson, 2005).³¹

Khader (2004) contends that what is more important is not who owns the company but how much freedom is given to the management. The separation of management from ownership can be achieved by restructuring the existing practice of handpicking the chairman, and by empowering the

30 Interestingly, Jawahar Lal Nehru, who was responsible for making the public sector a pillar of Indian economic strength, presaged the dilemma to be faced by Indian SOEs when he said after independence: “The way a Government functions is not exactly the way that business houses and enterprises normally function...When one deals with a plant and an enterprise where quick decisions are necessary, this may make a difference between success and failure. I have no doubt that normal governmental procedure applied to a public enterprise of this kind will lead to the failure of that enterprise”. But the essence of this message seems to have been lost over the years and was never translated into practice.

31 Isaksson, Mats (2005). OECD Guidelines on Corporate Governance of State-Owned Enterprises: A Tool for Value Creation. State Ownership Report.

boards with more authority and withdrawing government intervention. This is consistent with OECD's prompting that the government should not be involved in the day-to-day management of PEs; instead it should allow them full operational autonomy to achieve their defined objectives. The state should let defer to PE boards and respect their independence (Isaksson, 2005).

De-linking PEs from the control of the Ministry officials and functionaries would create enough space for the PEs to function effectively and focus on "performance" rather than "conformance". Stronger measures must also be adopted. For instance, there should be a clear separation between the state's ownership function and other state functions that may influence the conditions for PEs, particularly with regard to market regulation (Isaksson, 2005). Many have voiced an opinion that Article 12 of the constitution, is fundamentally wrong and is inconsistent with the principles of the setting up PEs as corporate entities (Ahluwalia, 2004)³² and should be amended. To really free the PEs from government control, this anomaly has to be set right and public sector employees should be categorized separately from the government employees.

Challenges and Benefits of Public Sector Corporate Governance Reform

The above governance framework follows several aspects of international good practice. Aside from the statutory corporations, CPSEs are corporatized. DPE guidelines have delegated decision making powers to the leading firms and other profitable companies and improved CPSE governance through the induction of independent directors and improvements to the performance monitoring system. Clause 49 of the Listing Agreement has been instrumental in putting listed CPSEs on the same footing as private companies. The 2007 Corporate Governance Guidelines are geared to raising further awareness and compliance with board, disclosure and other governance practices.³³ Yet, governance challenges still remain and further reforms are needed to build on the substantial gains that have already been achieved. The nature and extent of these challenges are bound to vary by type of CPSE – for example by size and importance of firm, delegation of powers, and listed vs. non-listed firms.

32 Ahluwalia, Montek Singh (2004). Conference of Chief Executives of Central Public Sector Enterprises, in Kaleido Scope, September.

33 Varrotil, Umakanth, India's Corporate Governance Voluntary Guidelines 2009: Rhetoric or Reality? (2010); Available at: <http://ssrn.com/abstract=163482>,

Four general observations can still be made:

- > First, corporate governance reforms are part and parcel of the broader CPSE reform program rather than a stand-alone or substitute reform. In this regard, broader policy reforms aimed at imposing market discipline are essential to bringing pressure on companies to improve governance – and to maximizing and sustaining the gains from such improvements. Substantial progress has been made in removing barriers to competition, reducing government financial support, and listing of CPSEs on the capital markets. But further market-based reforms are needed to cement these achievements and further enhance the competitiveness of CPSEs.
- > Second, how the state organizes and exercises its ownership rights is central to improving the governance of some of India's most important companies. The main challenge for GOI lies in making a complex ownership framework more effective in striking the right balance between CPSE autonomy and accountability. The present arrangements combine the conflicting roles of policy-making and ownership in some ministries, allow political interference in board appointments and commercial decision-making to continue, and weaken board powers. Strengthening the ownership arrangements to minimize these problems while further improving the MOU system to enhance accountability is thus a key challenge
- > Third, despite the advances that have been made, CPSE boards continue to be state-dominated, still lack sufficient decision-making authority in practice, and are rarely if ever evaluated on their performance. Professionalizing and empowering CPSE boards is another major challenge
- > Fourth, CPSE disclosure standards are comparable to many OECD countries and the RTI Act has pushed the frontier even further on transparency and accountability. Implementing these disclosure requirements however can be a major challenge for many CPSEs, particularly in light of relatively weak internal audit and control functions, lack of guidance on disclosure (particularly for non-listed firms), and potential duplication and delays in the various CPSE audits. Enhancing transparency and disclosure is thus the fourth main challenge
- > Addressing the above challenges and improving CPSE governance would make the state a more effective owner of CPSEs, achieve higher levels of CPSE performance and increase the value of

important national assets, bring capital market discipline, and achieve higher levels of transparency and accountability. As an integral part of business strategy and ethical value creation, improved corporate governance should help improve economic efficiency, increase investments, and achieve economic growth.

- > Governance reforms are ongoing processes that evolve and unfold over time. Managing these challenges will therefore require attention to the reform process itself, in particular to the need for: (i) political leadership and commitment; (ii) phasing or sequencing of reforms based on the political and institutional feasibility of reform; (iii) creation of strong institutions with dedicated reform teams to manage and sustain the process; (iv) building of public support to overcome stakeholder resistance to reform; and (v) development of monitoring systems early in the process to evaluate impacts, ensure transparency and accountability, and provide a feedback loop to adjust course as needed.

High profile corporate scandals like Enron, Satyam³⁴, have brought into public consciousness the mundane subject of corporate governance reforms in the hope that implementing good governance in organizations would not only prevent the recurrence of such problems but also lead to good organizational performance.

The last decade has also seen a flurry of regulations introduced across different countries in the world aimed at improving corporate governance practices in organizations; however, the results from such regulatory changes have been mixed. Mark J. Roe (2004) points to the inherent brittleness in corporate governance regulation...He suggests that we will continue to face corporate governance crises from time to time as new stress points develop and only if we're lucky, someone will anticipate the problem and fix it up beforehand, if not, we'll muddle through another crisis once again. (Kshama V K and Pande; 2012)

Indeed some have even argued that introducing corporate governance regulations is no guarantee that we have seen the last corporate governance break down.

Effectiveness of corporate governance regulations depends on having satisfactory answers to the following two questions;

³⁴ The Satyam scandal has been described as India's Enron perpetrating a \$1.47 billion fraud on its balance sheet India's Enron, *ECONOMIST*, 8 January 2009, Available at: http://www.economist.com/business/displaystory.cfm?story_id=12898777>.

- Are the regulatory changes in corporate governance based on sound theory or are they based on popular perceptions and a common position that is arrived at based on the negotiation of the divergent views of various interest groups who are affected by the regulatory changes?
- How robust is the underlying theory of corporate governance, in particular the linkage of good governance to good performance – does it comprehensively model all the factors that impact corporate governance and accounts for differences in contextual and cultural factors that could impact governance. Also, has the corporate governance theory been tested empirically based on actual conditions and have the conclusions been tested for their validity?

The current status of corporate governance research, especially an understanding of the factors that links corporate governance to good performance, has several gaps and conclusions derived from such findings, at times, do not hold up to rigorous testing.

Future Prospects for Public Sector Enterprises

Mr R Gopalakrishnan, Chairman, CII National Council on Corporate Governance & Regulatory Affairs stated, “A deeper understanding of ever evolving corporate governance scope is critical. Today it is more vital than ever to encourage and imbibe corporate culture.” Corporate governance reforms are critical to improving CPSE performance and competitiveness, increasing market discipline and access to new sources of capital, and achieving higher levels of transparency and accountability. There is widespread recognition in India of its importance, and the governance reform process has been well under way for a number of years. What needs to be done to improve further CPSE corporate governance is also widely recognized. Numerous commissions and expert groups have studied the issues in-depth and offered recommendations for improvement.

The challenge going forward is instead one of implementation. What can be done differently to expand and deepen the ongoing reforms? International experience suggests two broad factors for success. First, corporate governance reforms are and should be seen as part and parcel of a broader CPSE reform program rather than as a stand-alone or substitute reform. Reforms aimed at improving governance and increasing CPSE autonomy – such as board appointment and empowerment, separation of ownership from policy functions – can facilitate broader policy reforms aimed at increasing market discipline through exposure to competition,

tightening of budget constraints, listing of CPSEs on the stock exchange, and disinvesting through strategic sales and public-private partnerships. Market discipline in turn puts pressure on companies to pursue sound business strategies and good governance. It also helps maximize – and sustain – the gains from improved governance. Building on this dynamic addresses the core governance challenge of striking the right balance between CPSE autonomy and accountability.

Second, governance reforms and CPSE reforms more broadly are politically contentious and challenging to implement. Entrenched groups may oppose or find other ways to resist reforms. Implementation requires fundamental changes in organization, incentives, and behaviour that can be difficult to achieve. And governance reforms are ongoing processes that evolve and unfold over time. Managing these challenges will therefore require attention to the reform process itself, in particular to the need for: (i) political leadership and commitment; (ii) phasing or sequencing of reforms based on the political and institutional feasibility of reform; (iii) creation of strong institutions with dedicated reform teams to manage and sustain the process; (iv) building of public support to overcome stakeholder resistance to reform; and (v) development of monitoring systems early in the process to evaluate impacts, ensure transparency and accountability, and provide a feedback loop to adjust course as needed.

While the need to have public policy (relating to corporate governance) firmly grounded in sound theory is indisputable, there is the need to improve the robustness of research on corporate governance itself and develop a more robust theory for corporate governance –an area where several concerns exist at present. Despite a growing body of empirical literature on corporate governance reforms in India and their impact on Indian companies there is a need for further and more detailed research to fully understand the underlying issues that affect corporate governance in India. Only a proper understanding of the underlying issues would help in evolving a framework for reforms appropriate to the Indian situation and ethos, which would have much greater chance of success as compared to any ad hoc reform measures.

It would augur well for Indian companies if the corporate governance debate in the country were to transcend beyond conventional anecdotal wisdom and is based on research to facilitate the development of models that take into account distinctive Indian factors which are characteristic of the business environment in India. Indeed, corporate governance reforms in India now stand at an interesting crossroads, and the future development of

the next generation reforms and in their implementation during the current decade, will decide how effective they are for Indian business.

Towards the end it can be said that above assessment bring us back to the very quintessential question: how to design an institutional mechanism that limits (if not overcomes) the agency problem that is at the heart of modern capitalism with the separation of ownership and control of large firms, that puts hard budget constraint on firms, and reduces dysfunctional political bureaucratic interference.

Discussion Questions:

1. Is the overall model of corporate governance in PSEs satisfactory and how do PSEs measure up vis-à-vis the private sector?
2. Is the government able to strike an effective balance between its trusteeship and stewardship responsibilities?
3. Are PSE board structures appropriate and independent enough and are PSE boards actually focusing on the most important issues?
4. Does ownership structure matter? If it does, then, whether government ownership is more effective than private (including foreign) ownership in maximizing firm value?
5. When it comes to PSEs there is a perception in India that in certain areas, notably audit and accounts, they are over-governed thanks to the oversight roles being played by the Comptroller and Auditor General (CAG) and the Central Vigilance Committee (CVC). Yet there are several areas of deficiencies relating to accounting, audit and compliance matters which are highlighted. Where do the improvement levers lie?
6. What is your assessment of corporate governance in Indian Public Sector Enterprises and how does it compare with corporate governance practices in your country?
7. While governments have been successful in creating awareness about governance issues, they are yet to taste substantial success in terms of influencing institutional behaviour. Are there systemic issues that need to be addressed?
8. Businesses often take the easy route of complying with the letter of the law but breaking it in spirit. How can you instil ethics in corporate governance?

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BIOGRAPHY

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Chapter 26

**When NGOs invest the field of the Public Action:
Evidence from a Sub-Saharan Africa Country***KAHOU BI Faye Arsène & Konan Anderson SENY KAN***Abstract**

This chapter examines internal governance mechanisms within Non-Governmental Organizations (NGOs) in Côte D'Ivoire, a Sub-Saharan Africa (hereafter SSA) country. In this country the deleterious economic situation since the 1990s coupled with political instability has encouraged the proliferation of NGOs. They are now major third sector actors delivering essential public services where public authority fails. We explore the way coordination and control mechanisms underlying NGOs functioning are performed. This objective is investigated focusing on two questions: how do NGOs' managers use control mechanisms in coordinating their actions? How is the role of NGOs as public service providers institutionalized within a context of a less powerful State?

We employ a case study methodology involving two extreme cases. The NGOs' institutionalisation process and internal governance mechanisms is presented within a conceptual framework. Interestingly, the two cases reveal contrasting results.

We offer instructive explanations of two NGOs' activities which highlight two governance rationales. Whereas one of the NGOs has somewhat a classical governance system, that of the other one appears as unconventional. The results show that in developing country such as Côte d'Ivoire, fuzziness within State actions leads NGOs to act as social entrepreneurs investing public services' arenas more efficiently regardless of the governance mechanisms used. From this, several insights are provided to highlight contextual constraints over the functioning of internal governance.

Keywords: Third sector, Public services, Sub-Saharan Africa, Non-Governmental Organizations (NGOs), Corporate governance.

Introduction

NGOs have become major players in the third sector regardless of the relevant economy. They differ from for-profit organizations because of their focus on social mission as their main objective (Rivera-Santos & Ruffin, 2010). Broadly, they are:

“private, not-for-profit organizations that aim to serve particular societal interests by focusing advocacy and/ or operational efforts on social, political and economic goals, including equity, education, health, environmental protection and human rights.” (Teegen et al., 2004, p. 466).

NGO issues have gained momentum in management research in the last twenty years which is broadly structured around three key themes: governance³⁵ of NGOs (e.g. Cornforth, 2001, 2012; O'Dwyer & Unerman, 2007; Weerawardena et al., 2010; Weidenbaum, 2009), NGO-state relations (Coston, 1998; Young, 2000), and NGO-Business relations (Laasonen et al., 2012; Teegen et al., 2004; Rivera-Santos & Ruffin 2010). The majority of these studies involves western countries and has been extended in the recent years to developing countries' contexts especially SSA countries. With the exception of Brass (2010, 2012) whose studies focus on NGO-state relations or Kolk & Lenfant (2012) for NGO-Business relations, management research on NGOs focuses primarily on issues of governance in the context of SSA (e.g. Dixon et al., 2006; Goddard & Assad; 2006; Gugerty, 2010). The main concern in this strand of research could be summed up as follows (Gugerty, 2010; Lewis, 2001). Inefficiency in public actions has led international donors to rely on NGOs as crucial intermediaries in aid assistance. States' inability to tackle development issues has led international donors to extend their action beyond issues of humanitarian emergencies. However donors can face difficulties when attempting to assess NGOs' capabilities. Therefore, many call into question the governance of NGOs. In the late 90s, for example, the World Bank drew attention to the internal governance of NGOs highlighting such problems as a gap between stated mission and operational achievement; low levels of self-sustainability; lack of inter-organizational communication or coordination and limited expertise in economic or development issues (World Bank, 1998, p. 15).

Given the above, this chapter attempts to explore the way NGOs are managed in Côte d'Ivoire, a SSA country.

In Côte d'Ivoire, number of NGOs have increased over the past decade

³⁵ In this chapter the term governance refers to control mechanisms aimed at coordinating activities including accountability and performance issues.

because of the socio-economic crisis in the country since September 19, 2002. The number of Ivorian NGOs has clearly increased from 5 in 1990 to 49 in 1999 and 296 in 2008. Obviously, these figures are relative in the sense that the availability of data remains a big issue in developing countries. Moreover, even if such information is available, it is difficult to verify. For example, one of Ivorian federations of NGOs called FEDOCI, created in 2012, claims more than 500 members. In spite of this issue of availability of reliable data, it is clear that the proliferation of NGOs is the consequence of the failure of the State and also the inefficiency of public action accentuated by the 2002 crisis (Kahou Bi, 2012). For example, a mid-term review of the permanent mission of the United Nations System reveals that the poverty rate³⁶ in Côte d'Ivoire increased from 38.4% in 2002 according to the national survey on the living standards of households to 48.9% in 2008 (UN Report, 2012). At the same time the Ivorian NGO funding is estimated at approximately \$ 118 million in 2012 which represents only 49% of funding needs (UN Report, 2012). As is the case in most developing countries, the inefficiency of state agencies has gradually led to the disqualification of the states in managing international aid. Consequently, and increasingly, local and international NGOs, arguing their proximity to the beneficiaries, have become key players occupying a central position between the international donors and states. In the Ivorian context, NGOs play crucial roles through their social assistances: ranging from reconstruction of the country after a ten-year of conflict, learning from issues that led to the conflict, to changes in actors' behaviour and within the entire society.

However, although they are involved in strategic, tactical and operational roles in the provision of public services, they remain black boxes. Moreover, despite their proliferation, there is still little research that focuses on such organizations in developing countries notwithstanding the acuity of their governance problem. This chapter seeks to address this lack of discussion by addressing two questions. First, how do NGOs' managers use control mechanisms in coordinating their actions? Second, how is the role of NGOs as public service providers institutionalized within a context of a weak state?

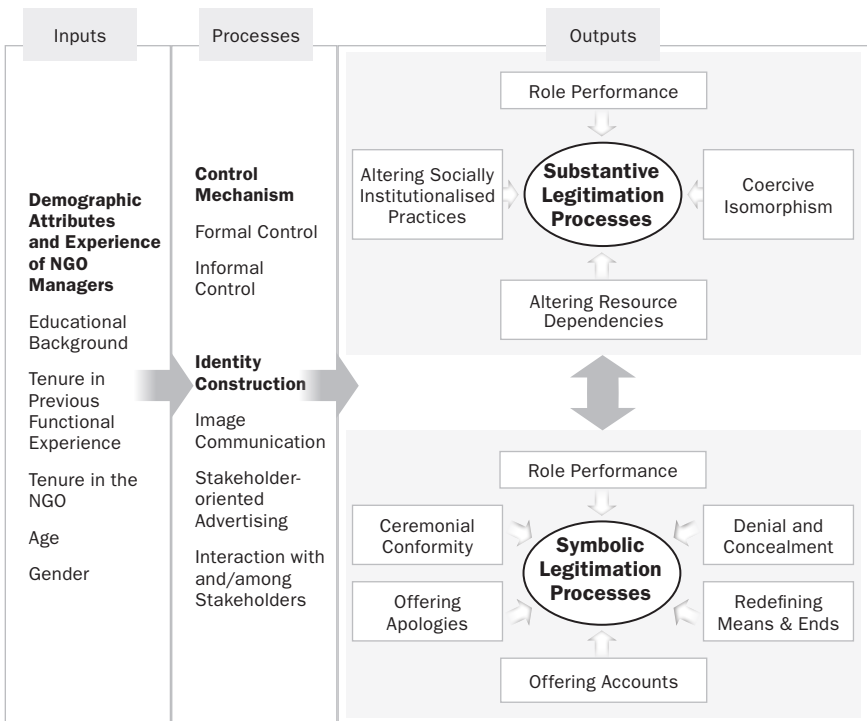
The chapter is organized as follows: the first section is devoted to the conceptual framework of the study. The second section describes the methodology used. The third section presents the results. The fourth section concludes the chapter through discussion, limitations and practical implications.

36 The poverty line in Côte d'Ivoire is 241 145 FCFA / year, ie \$ 476.73 US / year.

Conceptual Framework

We use an input-output model (Cronforth, 2001; Cronforth & Edwards, 1999) as a starting point to run our empirical work (*Figure 1*). Since NGOs are organizations “whose members combine their skills, means and energies in the service of shared ideals and objectives” (Rivera-Santos & Ruffin 2010, p. 55), the main inputs are arguably the demographic profiles of their managers. Demographic profiles are a focus of attention that echoes upper echelon theory proponents’ contention that organizational outputs, either materials or symbolics, are the reflection of its managers’ performance (Hambrick, 2007; Hambrick & Mason, 1984). These demographic attributes entail certain ways of running organizational and decision processes; especially control mechanisms aiming at coordinating activities as well as NGOs’ organizational identity construction.

Scott & Lane (2000) argue that an organization can construct its identity through three main mechanisms. These include first, a wide range of image communication tactics which may rely upon traditional forms of discourse such as advertisements, promotions, public speeches and newsletters as well as diverse meaning-laden actions. A second set of mechanisms publicizes stakeholders’ (donors, recipients, volunteers, etc.) affiliation. Such tactics may include disclosure of stakeholder lists and involvement of stakeholders in organizational advertising. The last set of mechanisms promotes interaction with the organization and/or among stakeholders. This can be done by an active sponsorship activity led by organizations whereby stakeholders are embedded in an organizational community. Some “cultural elements” contribute to the mechanisms included in the inputs inasmuch as these elements compose the institutional environment shaping organizations as well as the need to be efficient and effective (DiMaggio & Powell, 1983; Powell & DiMaggio, 1991). Paying attention to cultural aspects corresponds to the claim made by Lewis (2001, 2004) which is that decision making processes within NGOs are heavily culturally-oriented. Indeed, cultural consideration helps explain the variety among institutionalisation process that occur in our cases.

Figure 1: **FRAMEWORK TO ANALYSE NGOs' FUNCTIONING**

Inputs are combined within the control and identity construction processes which in turn result in outputs. The main outputs on which we concentrate are tasks performed by NGO managers in order to maintain the sustainability of their activities and to increase both the visibility of those activities and NGOs themselves. Therefore, NGO managers perform their tasks with objectives to institutionalize their role in the entire society through processes of legitimation. We identify many legitimation processes in the literature (Ashforth & Gibbs, 1990; Suchman, 1995).

In our data, we noticed that substantive and symbolic approaches (Ashforth & Gibbs, 1990) of legitimation processes were appropriate for the generation of compelling interpretations. The substantive approach of legitimation implies “*real, material change in organizational goals, structures, and processes or socially institutionalized practices.*” (Ashforth & Gibbs, 1990, p. 178) This approach involves four factors: *role performance, coercive isomorphism, altering resource dependencies and altering socially institutionalized practices.*

To clarify: when an organization merely endeavors to cope with expectations of stakeholders from which it captures critical resources, this is “*role performance*”. Performance expectations can either be economic, political, legal or normative.

Conformance to the values, norms, and expectations of stakeholders is a means whereby an organization seeks legitimation, leading ultimately to a “*coercive isomorphism*”. An organization can also attempt to gain more degree of freedom by multiplying its partnerships. This will result in an “*alteration of its resource dependencies*” with its current partners. In so acting, the organization increases its flexibility in the conduct of its activities. Finally, an organization can try to bring socially institutionalised practices to conformity with its ends or means leading to “*altering socially institutionalized practices*”.

On the other hand, symbolic approach of legitimation processes stress the fact that an organization attempts to maintain a certain kind of status quo while symbolic actions are undertaken to appear consistent with social values and expectations (Ashforth & Gibbs, 1990, p. 180). Depending on the set of actions undertaken (*espousing socially acceptable goals, denial and concealment, redefining means and ends, offering accounts, offering apologies to ceremonial conformity*), different tactics can be implemented. With the first set of actions, an organization uses various tactics to publicize certain goals but keep on pursuing some others. Tactics aimed at suppressing or hiding information likely to undermine legitimacy compose the second types of sets of actions. When tactics result in some attempts to provide new justifications to its conducts or “*identify an issue with actors, value, or symbols that are themselves legitimate*” (Ashforth & Gibbs, 1990, p. 181), an organization is said to perform the third set of actions. *Offering accounts*, the fourth set of actions, has something to do with tactics consisting in giving explanations with the purpose of shifting one’s attention from a situation that may reflect an unfavorably claim to legitimacy. The fifth set of actions called *offerings apologies* portrays an organization’s tactics that show its acknowledgement of the negative impact of its decisions, even partially. Finally the sixth set of actions reflects the situation of an organization that adopt ostentatiously visible practices that seem to be consistent with social expectations. This is done without setting up internally some coherent organizational and decision-making processes. Ultimately, we must recognize that whatever the process of legitimation managers’ objective is to promote towards their stakeholders that their organization’s activities are coherent with stakeholders’ expectations.

Methodology: Discovering the Management Secrets of Two NGOs

Given the paucity of management research on SSA's NGOs generally, and its scarcity in the particular context of Côte d'Ivoire, the aim of this chapter is to explore NGOs in order to initiate a stream of research work. We report on in-depth qualitative analysis of two NGOs (named NGO A and NGO B). That is not to say that case study is exclusive of an exploratory research (Woodside, 2010; Yin, 2009). One of this chapter's authors has been in touch with both NGOs since November 2008 during his doctoral studies. This longstanding relationship with both NGOs was very helpful for gathering empirical data because access to a research field remains difficult in Africa. Indeed, as African managers have a great culture of secrecy, it is not easy to enter their organizations. Moreover, they are not sensitive enough to research the issues themselves.

Due to the long lasting relationship with both NGOs, our interviewees have behaved as *"informants rather than respondents"* (Yin, 2009, p. 107). We were even able to apply a mixed method strategy to collect data through two series of interviews in 2008 and 2012. We also used archival records (of documents such as registration documents, statutes, bylaws, annual reports, written records of general meetings and extraordinary meetings). Online reports released by the Ivoirian representation of the United Nations Office for Coordination of Humanitarian Affairs were also useful in a triangulation perspective. NGOs A and B are two *"extreme cases"* (Yin, 2009, p. 47) in the sense that they are so different that each of them gives an in-depth insight of NGOs' management in Côte d'Ivoire. Both NGOs are different in terms of creation context, founders' background, social mission, and source of finance. The table below summarises the distinctive features of both NGOs and the details of the interviews.

Table 1: **NGOs' FEATURES AND DETAILS OF INTERVIEWS**

Features	NGO A	NGO B
Year of Creation	1998	1998 (NGO B is the Emanation of an Association created in 1985).
Founder's Profile	A 54-year old woman. She holds a Master in International Business. She was an international civil servant for many years including UNHCR African Great Lakes Region.	A 46-year old man. He holds secondary education background, and manager of an SME specialising in the sale of medical devices.
Social Mission	First founding missions: income-generating activities, capacity building, health, child protection, HIV / AIDS and welfare. Second founding missions: child protection.	First founding missions: poverty reduction (micro credit, village pump repair) Second founding missions: Healthcare (Creation of medical centres in rural areas).
Annual Budget and Fund Sources	250 million FCFA (\$ 494 658. 95 US) funded mainly by international donors and a small portion of the contributions the Board members.	3 million (\$5 935.1 US) funded primarily by own funds, income from medical services and to a lesser extent by state subsidies.
Interviews	The Founder, who is also the General Coordinator and the Project Manager (in 2008) and the Project Manager, a Director and the Financial Manager (in 2012).	The Founder, the General Secretary and the Accountant Assistant (in 2008) and the Founder (in 2012).
Average Length of Interviews	1:30	1:00

We have selected NGOs A and B from a perspective of replication logic (Eisenhardt & Graebner, 2007; Yin, 2009). It means that each NGO constitutes a unit of analysis within the case study as a whole. We have taken our conceptual framework from literature to provide a guide for data collection. Thus, the conceptual framework is used as a template to generate our results. However, we use knowledge other than that contained in the conceptual framework to deepen the understanding of the issues under investigation, when necessary and appropriate. This proceeding is what Yin (2009) names an “analytical generalization”.

Results: Incursion Into the Organizational Machinery of the Two NGOs

The results show how input components are pivotal in the performance of coordination and control mechanisms underlying NGOs functioning. This determines, in turn, distinctive ways in how NGOs manage to gain credibility and institutionalize their provision of public services.

“Inputs” as the ingredients for the creation of NGOs A and B

First, we show that the demographic profile of NGO A's founder is closely linked to her long experience in international NGOs whereas that of NGO B's founder is unrelated to NGOs' activities. Second, we show how regardless of these contrasting demographic profiles, the founders of both NGOs act as social entrepreneurs.

Demographic Attributes within NGOs A and B

By focusing on the demographic characteristics of NGOs managers, we implicitly draw a parallel with the upper echelon theory (Hambrick, 2007; Hambrick & Mason, 1984). The core premise of this theory is that the performance of a given organisation relies on its managers' demographic attributes such as their educational backgrounds, experiences, values, personalities, etc. In effect, choices made by managers depend on the interpretation of situations they face. And those interpretations are shaped by their demographic attributes. It is noteworthy that the two central ideas of this theory require a contextualisation to NGOs. Accordingly, we argue that NGOs managers' decisions are tightly consistent with their own interpretations of the strategic situations they deal with. In addition, these personalized interpretations depend on managers' experience, value and personality. Ultimately, NGOs' outcomes mirror their own biases in the sense that their demographic attributes affect the directions they look and listen (field vision), what they actually see and hear (selective perception), and how they relate meaning to what they see and hear (interpretation) (Hambrick, 2007). It is important in this context to note that the manager and founder of NGO A (hereafter manager A) holds a postgraduate degree in International Business and she gained a long-period experience working as an international civil servant in several western international NGOs present in the African Great Lakes Region (including Democratic Republic of Congo, Burundi, Rwanda, Uganda and Tanzania). Since the early 1990s this region has been upset by genocide, civil wars, interstate conflict and flawed democratic transitions. At the end of her contract in the African Great Lakes Region, she returned to her native country, Côte d'Ivoire where, in 1998, she created her NGO with the support of some prominent persons (Doctors, Lawyers, Workers of UN agencies) to provide assistance to Liberian refugees in western Côte d'Ivoire. As one interviewee stated:

“Her idea was to duplicate the organizational structure and functioning mode of the international NGOs in which she had been working in the Great Lakes region. Thus, during the war in Liberia, we assisted displaced persons.” (NGO A Project Manager)

Liberia, which borders the western Côte d'Ivoire, has experienced two civil wars: the first in 1989-1996 and the second in the period 1997-2003. NGO A works in collaboration with the UNHCR. In contrast, NGO B's manager (hereafter manager B) does not have a postgraduate degree. He has a secondary education background and he is employed as a medical equipment salesman. The NGO B is a simple extension of an association of his home village. This association is composed of those living in the Ivorian capital city, Abidjan but who are natives of the same village as manager B. It is important to understand that developing countries are structured almost identically. Indeed, only a few cities are urbanized in these countries. Among these cities is the capital, which is the flagship city of the country. Being representative of the promise of a job and thus an improvement in living conditions, the capital is the focus of a massive rural exodus. Consequently, people living in capital cities are from different villages and regions but, due to an unwavering commitment to their villages and regions, there are a myriad of villages and/or regional associations in capital cities through which members attempt to support the development of their respective home villages and regions. Thus, NGO B was created in 1998 as an extension of a region association. As manager B himself, stated:

“Actually, it is our village's association which has been transformed into an NGO. But the association itself is still there. We made this transformation to improve help to the community of our region.”
(NGO B Manager)

Compared to manager A, manager B had no experience in managing an NGO at the time of the creation of their respective NGOs. Among the activities that NGO B is currently conducting or had conducted only that of healthcare is to some extent related to the job of its manager. Conversely, activities in NGO A are a tight reflection of the prior functional experiences of manager A. Furthermore, staff members in NGO A have an educational background related to their respective function or to the task they are assigned. This is not the case in NGO B.

Social Entrepreneurs in Action

At its inception, NGO A was engaged in a variety of activities which can be classified into three categories: reduction of poverty, healthcare

and human development. In the first category, actions were focused on the creation of income-generating activities for refugees and poor people, and capacity building for the beneficiaries of those activities. In the second activity, the focus was on healthcare in general and HIV / AIDS in particular. And in the latter activities, human development, efforts were devoted to child protection and well-being. But, progressively, the scope of activities has narrowed through restructuring policy by refocusing on the protection of children. Especially after 2007, the NGO A was more involved in assistance to displaced persons and shortly after, in the assessment of the need for these displaced people. From 2010, the main concerns have been concentrated on human development including efforts to address questions of statelessness.

The activities of the NGO B were initially concentrated on poverty reduction. The first actions were concentrated on the provision of microcredit for unemployed young people to run some small income-generating activities. Thereafter, the NGO is interested in the repair of hydraulic pumps in the villages. Finally, the NGO is entirely devoted to health care issues in rural areas by creating some small medical centers.

According to some streams of research in the third sector literature, activities of managers A and B can be typified as what it is henceforth called “social entrepreneurship” (Neck et al., 2009; Peredo & McLean, 2006). Social entrepreneurship can be defined as undertakings:

“where some person or persons (1) aim either exclusively or in some prominent way to create social value of some kind, and pursue that goal through some combination of (2) recognizing and exploiting opportunities to create this value, (3) employing innovation, (4) tolerating risk and (5) declining to accept limitations in available resources” (Peredo & McLean, 2006, p 64).

By linking this definition, which highlights the attributes of social entrepreneurship, to the aforementioned demographic attributes of both NGOs’ managers and the creation contexts of NGOs A and B; we offer the following insights (Table 2).

Table 2: **LINKING NGOS’ MANAGERS “ATTITUDES FOR RUNNING ACTIVITIES” TO THEIR “SOCIAL ENTREPRENEURSHIP ATTRIBUTES”**

NGOs Manager and/or Founder	Attitudes for Running Activities			Social Entrepreneurship Attributes				
	Field Vision	Selective Perception	Interpre- tation	Social Value Scope	Opportunities	Innovation	Risk Aversion	Sensitivity to Limitations in Resources
Manager A	High	Hlgh	Hlgh	Entire Community	Based on Expertise	Continuous Changes in Founding Mission	High	High
Manager B	Low	Low	High	Specific Community	Based on Intuitive Rationale	Radical Change in Founding Mission	Low	Low

Due to her demographic profile, the founder of NGO A has a clear understanding of its functioning. Conversely, the manager B who is inexperienced in running an NGO manages via “trial and error” (Hofstede, 1981, p. 196). However, like the founder of NGO A, he is well aware of realities he faces. As manager B emphasized:

“We started with a project dealing with poverty reduction by giving money to a dozen young to get a small business, some of them took the opportunity to go on an adventure (France, USA, etc.). We concluded that it was a trial, so this project was dropped. Then, rural development project was tried, consisting of in developing repair activities of hydraulic pumps in villages, financing was done on equity. Therefore, we concluded that poverty reduction needs a lot of money and it is not easy to get funding for well doing business. So we started investing in healthcare activities.”(NGO B Manager)

In addition, while it is clear that both NGOs have apparent social missions (Neck et al., 2009), their respective mission differs in terms of the scope of its “social value” (Peredo & McLean, 2006, p 59). NGO A runs its activities to contribute to the welfare or well-being of the entire community, whereas NGO B is primarily dedicated to the community of its region. A socially-oriented founding mission and an ability to capture opportunities are two critical starting points for social entrepreneurship (Neck et al., 2009, p. 15). In any developing country the deleterious economic and political situation unfortunately causes social problems. It is the ability of the managers of NGO to identify the “social opportunities” to address these social problems that plays a central role in managing NGOs. In this research, drawing on her long-period expertise and educational background, manager A accomplished this task whereas in NGO B decisions are more intuitive.

Consequently, in terms of innovation,³⁷ both manager A and B adopt different approaches to adapt to situations. This results in a process of continuous change in the founding mission of NGO A. By way of contrast, in NGO B changes in founding mission were more radical. We note from the above that manager A having a better understanding of NGOs in developing countries testifies to a greater risk aversion and sensitivity to constraints in resources whilst manager B does not, in accordance with his intuitive way of doing things.

Control and identity construction processes

NGOs may play three basic roles that determine their embeddedness in a complex relational network of stakeholders. They can play distinctive and/or cumulative roles of implementer, catalyst, and partner (Lewis, 2001), which link them in a different manner to donors (international and national), government agencies, recipients, and community as a whole. As an “implementer”, an NGO conducts its own project aimed at the mobilization of resources to provide goods and services or is engaged by a stakeholder (mainly government or donor), to carry out specific activities in return for payment. “Role catalyst” refers to an NGO’s ability to inspire, facilitate or contribute to changes by seeking to influence wider policy processes. If undertaking a “partner” role, an NGO works with its stakeholders on joint activities as a “capacity builder”.

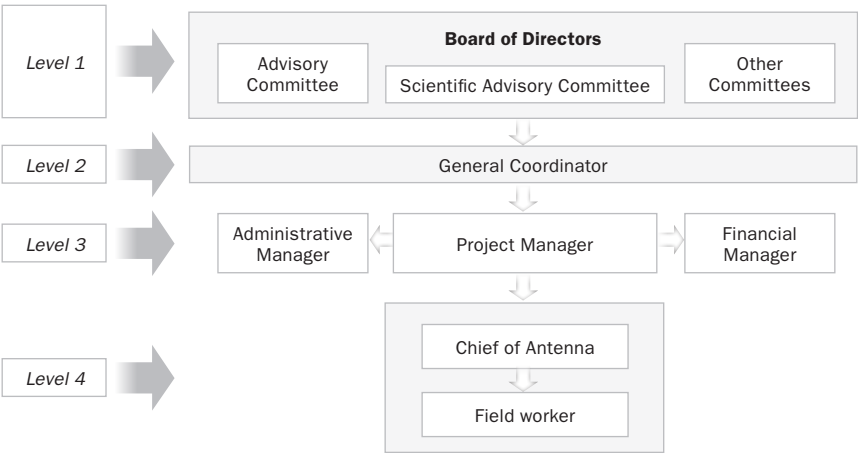
We find that NGO A acts as an implementer and partner for three Ivorian government agencies (Ministry of Solidarity, Family, Woman, and Child; Ministry of Education; and the National Agency for Support to Rural Development), five UN agencies (UN Refugee Agency, International Labour Organization; World Food Programme; United Nations International Children’s Emergency Fund (UNICEF); and United Nations Development Programme), and two other international organizations involved in tackling child labour (Global March and International Cocoa Initiative). This multiplicity of actors leads to a diversity of programmes and projects in which NGO A is involved. Accordingly, as noted in the previous section, the scope of the social value of its activities is greater as it affects a large population of recipients located throughout the entire Ivorian territory. Conversely, as NGO B is an extension of a region association, its social value scope is narrower. Vis-à-vis its recipients, NGO A assumes the sole role of implementer of programmes and projects. In contrast, NGO B plays a single role of implementer with the Ivorian Ministry of Health whereas it

37 In management literature, a strand of research contends the idea that innovation can no longer exclusively be associated to technology (e.g., Ganter & Hecker, 2013; Mol & Birkinshaw, 2009). Indeed, innovation may involve organizational aspects such as new practices, etc. The latter interpretation is applied in this research.

acts as a catalyst for its recipients who are basically community members of manager B’s native region.

These contrasting relationships with stakeholders partly explain the different issues of control and coordination for NGO A and B and the related modalities to deal with them. Control and coordination are more formal in NGO A than in NGO B. From the traditional management literature (Child, 1973; Lawrence & Lorsch, 1967), we define control as actions taken within the organization in order to ensure that established expectations can be met effectively. We identify coordination as a set of collaborative actions aiming at bringing together diverse efforts which are spread within the organization. In NGO A, control is more formal and takes primarily a bureaucratic form (standardization, written procedures, reporting). As shown in the chart below, the organizational structure of the NGO A is based on a clear chain of command (hierarchical line) (*Figure 2*).

Figure 2: EXCERPT OF ORGANIZATIONAL STRUCTURE IN THE NGO A



Levels 1 and 2 include top bodies and individuals in the chain of command. The Board of Directors is exclusively composed of non-executive directors participating in NGO A on a voluntary basis and only after paying a fee of 100,000 FCFA (\$199.88 US) and an admission fee. This can be seen as an innovative fund raising. Directors are chosen for the relevance of their professional background in relation to areas of intervention of the NGO A. Thus, the Board of Directors of NGO A includes chartered accountants, lawyers, doctors, in short, prominent persons. These directors advise the General Coordinator (the founder) who also serves as the Chief

Executive Officer. Staff members are recruited via calls for applications. In any case of disagreement between the Board and the General Coordinator about recruitment issues, the NGO A asks for the expertise of a recruitment agency. In this regard, one of our interviewees stated:

“In fact, this year we had trouble with the directors for the choice of the head of the human resources. We had then turned to a recruitment agency. We are one of the few non-governmental organizations to do so.” (NGO A Project Manager)

As in many for-profit ventures, the Board of Directors assumes a monitoring function over management activities undertaken through levels 2 to 4 via approval of budgets and disbursements.

“At the end of the year, the General Coordinator reports on its activities to the Board of Directors. The Board of Directors, especially the treasurer of the board sees the possibility of signing for the funds to be disbursed. So that before the disbursement of funds, directors know the decisions that are taken.” (NGO A Project Manager)

From the functional point of view, level 3 provides transversal supportive activities for the functions of level 4. NGO A has five units (called Antennas) covering the entire national territory. In each of these entities, the level 4 of the organizational structure is duplicated. Feedback on the management is provided every morning through staff meetings coordinated by the Project Manager. The reports of these meetings fuel the meetings of the Management Committee coordinated by the General Coordinator. The Management Committee is composed of 10 members including three Chiefs of Antennas.

The fieldworkers carry out their duties in accordance with some pre-established “terms of reference”. The terms of reference provide specifications which facilitate control over activities. Human Resources management is no exception to this formalization. Indeed, executives of NGO A are expected to have a post-graduate diploma awarded at an university or a business school. Each employee of NGO A has a record of recruitment which includes a detailed description of her/his position, a code of conduct and a by-law. Employees are evaluated at the end of each year by their corresponding supervisor. This evaluation is documented in an evaluation form.

The accounting and financial information is also organized in a sophisticated way within NGO A. Besides meetings (staff, management committee, and general meetings), a central pillar is the budget which is representative of a coordination channel. The launch of a project is studied

by a technical team. The appropriateness of this project is appreciated by the General Coordinator and submitted to the Financial Manager. The disbursement of funds for the implementation of the project is subject to three signatures (of the General Coordinators, the beneficiaries and Financial Manager). In this NGO, any organizational and decision-making processes (control and coordination actions), are based on a set of standardized procedures.

It is interesting to note that this method of control and coordination is almost absent in NGO B. However, when they exist, they are implemented a different manner. Here every project results in a new organizational structure. As the founder stated:

“Our organization is variable depending on the activity and project we get. In other words, there are several ways to organize ourselves.” (NGO B Manager)

The organizational structure of NGO B looks like what it is called in strategic management literature “modular organization” (Benassi, 2009; Daft & Lewin, 1993; Richard & Devinney, 2005; Sanchez & Mahoney, 1996). Modular organizations are kind of organisations which are defined as:

“learning organisations that continuously change and solve problems through interconnected coordinated self-organizing processes” (Daft & Lewin, 1993, p. i)

In addition:

“A modular organization can be depicted as a nested set of units within a larger organization” (Benassi, 2009, p. 187)

Within modular organizations, modules are intentionally created around a core structure (Sanchez & Mahoney, 1996). In NGO B’s organizational structure, projects constitute modules overseen by a central structure formed by senior executives. The main field of action of the NGO B is the native region of its founder. Thus, the modular functioning allows NGO B managers to involve volunteers, native from the region who wish to serve their community. In terms of human resource management, this poses a real challenge for NGO B. In fact, for each project, new volunteers are recruited regardless their skills and are trained in a process of learning by doing. The interview excerpt below provides an illustration:

“[Question]: And how do you make your recruitments?”

[NGO B Manager]: Often we work with people who know nothing about. It is in the course of the project that we give them training in relation to their responsibility in the project.”

Paradoxically, the modular functioning provides several advantages to the NGO B (highlighted by Benassi (2009) in the context of for-profit ventures). The first strength has to do with making control issues easier, prompting focus, and increasing volunteers' commitment to their community. In particular, when compared to NGO A, control in NGO B is less formal and relies more on the social codes of mutual aid culturally widespread within African communities. The second strength has to do with flexibility. For instance, in 2010, NGO B faced a lack of fund raising from international donors, so its officials decided to close their head office in the capital and to devote itself to creating health centers in rural areas. As the founder stated:

"Given the lack of means, we directed our actions towards the establishment of medical centers that give us substantial financial resources." (NGO B Manager)

Since then the activities of NGO B are so viable that, at the time of our second interview two other medical centers were being created at Adiaké, a southeastern town of Côte d'Ivoire that has been fighting a serious cholera epidemic since 2012. In other words, the experience gained by the NGO B in the home region of its founder is implemented in another region of Côte d'Ivoire.

In terms of financial and accounting disclosure, NGO B complies with the minimum requirements by releasing an annual report. There are no financial auditing activities. NGO B simply releases a report of its activities illustrated with photographs as the unique proof of its financial and accounting transparency. The conversation excerpt below is illustrative of the lack of formalization within NGO B:

"[Question]: Have you ever done an audit of your NGO to know what works and progress actions to be taken?"

[NGO B Manager]: No! Are you making a proposal?"

By way of comparison, it appears that while control and coordination are implemented in different ways, both managers A and B share a common idea that gaining and/or maintaining credibility with respect to their respective networks of stakeholders is essential and can be achieved through the construction of an organizational identity. Interestingly, they place control and coordination at the service of the organizational identity construction of their respective NGO. Thus for NGO A, the high degree of formalization of coordination and control tools guarantees an image of a rigorous organization. In particular, formalization of financial and accounting processes is a vehicle for an organizational identity construction focused on internal interactions as well as interactions with

stakeholders (especially its international donors). The construction of organizational identity by NGO A also involves external communication based on modern tools such as a website, gadgets, T-shirts, etc. Its focus is on image communication, capitalizing donors' image, and advertising involving recipients. These ways of organizational identity construction are still, nevertheless, in their infancy stage.

For NGO B, the construction of organizational identity is ethnically oriented due to the fact that this NGO is the emanation of a region's association. This is reinforced by its modular organizational form which in turn strengthens an intra-ethnic solidarity commitment. With the creation of medical centers at Adiaké, this intra-ethnic solidarity is extended beyond the borders of the region of origin of NGO B. Ultimately, within this NGO, the construction of organizational identity is only focused on the relationship with stakeholders who are mainly the recipients. These relations are coordinated informally and rely on a fundamental cultural value in Africa which is solidarity among community members.

Inputs and processes as contingencies leading to two contrasted legitimacy processes

In this study we were interested in two legitimization processes: substantive and symbolic (*Figure 1*). Our results show that NGO A, since its inception, pursues a substantive process of legitimization while NGO B implements both processes. As we noted, the substantive legitimization process can be carried out through four sets of actions: role performance, coercive isomorphism, altering resource dependencies, altering socially institutionalized practices (*Figure 1*). We discuss how these actions are apparent in NGO A. In respect of "role performance", the organizational structure and even the decision-making were designed by NGO A's founders to meet their requirements in terms of efficient management. As the NGO A Project Manager emphasized:

"We work in accordance with the collective agreement, labor law, the code of conduct patterned on the United Nations system agencies and finally in accordance with our own internal rules of procedure." (NGO A Project Manager)

Explaining the financing difficulty that may encounter some small NGOs, this interlocutor also argued that it is the lack of formalization conform to international donors' requirements which explains why small NGOs are unable to raise funds. Her statement below shows NGO A managers' awareness of performance expectations of international donors.

"You know, it is small organizations [NGO] which, in my opinion, do not want to afford to gain opportunities with [International] donors."

There are simple things that donors require. They are interested in a good management process of their funds. Because donors are in turn dependent on their own donors ([US] State Department, for example). Therefore, they have to be accountable. In short, these donors simply require management tools for their funds allocated.” (NGO A Project Manager, our emphasizes in brackets)

This shrewdness can be likely associated to the experience of NGO A's founder (the General Coordinator) as an employee of international NGOs in the Great Lakes region of Africa. Even in terms of organizational identity construction, NGO A is still fitting to its international donor practices. As the Project Manager of NGO A stated:

“We have a General Coordinator who has long worked with UNHCR. UNHCR does not make advertising unlike, for example, UNICEF. So she worked long without advertising. It is only in recent years that we focus on communication.” (NGO A Project Manager)

These “role performance” actions lead unquestionably NGO A to be subject to a coercive isomorphism. But, contrary to Ashforth & Gibbs (1990), the *coercive isomorphism* in NGO A is not a simple invocation of conformity to the expectations of its international donors. Indeed, NGO A's manager is completely aware of the fact that the fulfilment of international donors' expectations determines the survival of their activities. In fact, it is noteworthy to notice that even though NGO A is in partnership with three Ivorian government agencies, it is not funded by them. So having multiple stakeholders (five UN agencies and two international organizations) can be interpreted as an “*altering resources dependencies*” strategy implemented by NGO A in order to minimize the cessation funding flows. Basically, this strategy also explains why NGO A is only involved in national assistance programs which result in the larger social value scope of its missions and a multiplicity of international donors. For instance, the geographical repartition of NGO A entities (Antennas) perfectly fits one of the “humanitarian priority zones” delimited by the UN system. The mix effect of these first three sets of actions dedicated to the substantive legitimization process induces the fifth, ie *altering socially institutionalized practices*. The way NGO A behaves disproves a generally accepted idea claiming that African organizations cannot reflect the manner in which western organizations are managed. More interestingly, the NGO A shows its ability to adapt a conventional governance mechanism such as the board of directors by introducing admission fees for future directors.

On the other hand, NGO B had attempted a substantive legitimization process at its inception. Indeed, as an emanation of an association, NGO B sought to play an implementer role with international donors to capture financial resources that would enable it to assume its catalyst role towards its beneficiaries. This implementer role worked quite well for a while with the manager considering that his best success was when NGO B was assuming an implementer role for international donors. Specifically, in 2008 NGO B was funded by Care International, an international NGO, for HIV / AIDS awareness program in his native region. As he stated:

“Once, we were four NGOs to be funded by Care International 36,000,000 FCFA [\$70,920 US]. It was at Séguéla in 2008. We [ONG B] received 8,000,000 FCFA [\$15,760 US].”

(NGO B Manager, our emphases in brackets)

He added later:

“Our biggest success is when we got the awareness component of an HIV/AIDS project with three other NGOs in the region.”

(NGO B Manager)

But NGO B's inability to implement the four sets of actions relating to the substantive legitimization process has had two consequences. The first was the cessation of financial flows by international donors. This led NGO B to shut down its headquarters because of its inability to meet the rental obligations. The second consequence was then a radical change in its founding mission. The implementation of the new founding mission, ie the creation of medical centers, is accompanied by a legitimization work which takes rather symbolic traits which comprise espousing socially acceptable goals, denial and concealment, redefining means and ends, offering accounts, offering apologies to ceremonial conformity. Firstly, the creation of medical centers is a response to the health care problem in Côte d'Ivoire as identified by NGO B's manager. Indeed, the lack of access to healthcare is endemic in Côte d'Ivoire like in most developing countries. This problem is more pronounced for populations living in rural areas. Thus, after the failure of its first founding missions, tackling a problem that government authorities have never been able to find a lasting solution is to espouse a socially acceptable goal for the members of the association who created NGO B. So improving the access to healthcare makes sense to the members of the community for who NGO B was created. Secondly, shift in founding missions of NGO B remains, whatever the explanation that its managers want to provide, an admission of failure per se. But NGO B's managers in denial and concealment strategies aimed at ensuring themselves and

also their community invoke another reason for their first failures. As the manager B stated:

“The NGO is doing not so bad. Because of the crisis who has prevailed, we no longer have operational headquarters here in Abidjan. But we continue to exist. We have now two representations at Adiaké. Given the lack of financial resources, we directed our actions towards the establishment of medical centres that constitutes our main sources of income.” (NGO B Manager)

Thirdly, the above statement shows how NGO B's managers justify the *redefinition of means and ends* of their activities, and at the same time *offer accounts*. They call into question the lack of financial resources induced by the war occurred between the two candidates (Laurent Gbagbo and Ouattara Alassane) in the Ivoirian presidential elections of 2011 and not their inability to comply with the formalization requirements of their organizational and decision-making processes dictated by international donors. Arguably, one can remain skeptical as regards this argument because paradoxically international NGOs have been mobilized massively in the context of post-crisis reconstruction. Nevertheless, in terms of means, the NGO receives payment from beneficiaries for health care as its main source of funds supplemented for a lesser part by government subsidies. In accordance with its social mission NGO keeps healthcare costs cheaper than public hospitals and private clinics. Also in terms of ends, while creation of Adiaké entities may seem opportunistic, it is clear that NGO B has extended the scope of the social value of its actions beyond its original target population. Indeed, tackling the cholera pandemic which has prevailed in the southeastern region has social values and symbols that make sense to some stakeholders mainly the beneficiaries themselves but also government agencies. Fourth, even if manager B statements do not reflect tactics of *“offering apologies”*, the above results show a recognition by NGO B of the ineffectiveness of its initial strategies. However, *ceremonial conformity* is very prominent within NGO B. Indeed, while the statutes of NGO B clearly indicate the existence of governing bodies such as a board of directors, board committees and formal decision-making procedures, its day to day activities remain informal and completely embedded in the traditional values of community solidarity. In the end, the NGO B works to improve its legitimacy through the change of its founding missions without changing the inner workings of its organizational processes and decision-making. Despite this informal functioning, the social value of NGO B's actions is quite well perceived

by the community because NGO B is often asked to share its ground experiences.

Discussion, Limitations and Practical Implications

This chapter has to be viewed as an unprecedented journey within two NGOs in SSA. Through an input-output model used as a starting point, it offers readers an understanding of the way coordination and control mechanisms underlying their functioning are performed. Two questions have guided us in this journey. The first has sought to explore the manner in which NGOs' managers use control mechanisms in coordinating their actions. The second have stressed on the way these NGOs institutionalized their activities.

We show how the fuzziness within state actions leads NGOs to act as social entrepreneurs investing public services' arenas more efficiently regardless of the governance mechanisms used. We are not trying to contend that governance debates on SSA's third sector are irrelevant, but they should rather be more contingent. Indeed, we offer evidence that NGOs actions are institutionalized through distinctive ways of doing things that are closely linked to the demographic profiles of their founders and also the NGOs' creation contexts. Both elements might be seen as contingent factors, among others.

We find that NGO A is representative of the western "mainstream" rationales underlying corporate governance. In this respect, international donors as major external funders can be seen as drivers of western governance rationales. But the alignment of NGO A internal processes on international donors' objectives has a profound reliance on the demographic profiles of NGOs' founders. In turn, the demographic profiles seem to determine the ability of the NGO A as a whole to set up internal processes that fit donors' requirements. Consequently, NGO A conducts a work of legitimization, within a logic of institutionalization of its activities, to satisfy international donors. Results on NGO A suggest, in contrast to Ashforth and Gibbs (1990), that substantive legitimization process may not involve changes in socially institutionalized practices. Indeed, in accordance with the experience of NGO A's founder, organizational goals, structures, and processes of NGO A were set up purposely earlier at its inception.

NGO B operates informally. It experienced a shift in its institutionalization tactics which starts with an attempt of a substantive legitimization process to finally focus on a symbolic legitimization. The way NGO B works on

its legitimacy towards the beneficiaries has to do with trust. In most SSA countries ethno-regional communities are far more meaningful in interpersonal relationships (see Ndulu and O'Connell, 2008). In other words, trust is to some extent more likely to be ethnocentric. It plays a fundamental role in the community solidarity experienced by NGO B, so that no matter what its internal processes, what people primarily think is that this NGO is made up of members of their community trying to solve some of their basic living problems. Peterson (2010) suggests that investigating trust may help to deal with the paucity of NGO literature. We add that while in western rationale, trust is enforced throughout a nexus of contracts, in SSA it could be considered as a subtle contingency with cultural features in decision processes.

From the empirical results we can contextualize the conceptual framework used in the following manner. When an NGO's founder whose demographic profile reflects previous experience in NGOs, he/she is likely to establish formal coordination and control mechanisms in order to legitimize its activities through substantive processes. Conversely, when his/her demographic profile has absolutely nothing to do with the management of NGOs, it is more likely for him/her to set up original coordination and control mechanisms attempting to legitimize NGO's activities via symbolic processes.

The methodology design of this chapter has its own validity and reliability issues. The use of two contrasting cases gives fruitful insights on a complex and relatively unexplored issue but some further research avenues can usefully be identified. First, our study suggests different ways of managing NGOs in Côte d'Ivoire in accordance with some contingent factors. It can be extended to more Ivoirian NGOs in order to scrutinise variety of contingent factors and whether patterns can be identified. Second, investigation of NGOs' internal processes in the relation with types of social missions pursued can usefully complement our results. Third, another way to supplement this research might be a focus on NGOs stakeholder perception in the line of some authors (O'Sullivan & O'Dwyer, 2009; Wellens & Jegers, 2013). Forth, in a comparative perspective, the aforementioned research avenues could be investigated in other SSA countries.

Despite the above research avenues, our findings have important implications for NGO's in Côte d'Ivoire and more widely in SSA. We evidence that NGO A and B are respectively a "primarily donor-funding-based" organisation and an "earned income oriented activities"

organisation (see Weerawardena et al., 2010). Each of them develops a specific way to coordinate its internal processes and institutionalize its activities. NGO A directors's appointment conditions are representative of an innovative strategy regarding their commitment. Or the modular organization form of NGO B is another innovative way to adapt to circumstances. For government agencies, our findings could be a basis to set up programmes aimed at guaranteeing the sustainability of NGOs' activities or at least engage debates on how NGOs can be supported. NGOs in SSA, especially in Côte d'Ivoire, have become essential non-state relief actors. A good understanding of how they work can help to understand determinants of their sustainability.

Discussion Questions:

1. How could the conceptual framework (see "Conceptual framework" section) used in this study be reformulated given the empirical results of the case study?
2. Referring to the agency theory perspective on NGO governance proposed by Peterson (2010), what complementary analysis could be made about the governance peculiarities of the NGOs A and B?
3. Discuss how coordination and control mechanisms within NGOs A and B challenge the conventional one-tier and two-tier governance system.

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BIOGRAPHY

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Chapter 27

Mi Casa Es Su Casa? Leadership Challenges in Non-Profit Governance

Adrian Velazquez

Abstract

Casa Guanajuato began as a means of celebrating Mexican culture and to promote sports as alternative activities to the neighborhood's bad influences. Since a large number of Mexican migrants live in an impoverished area of the city, social pathologies are prevalent and affect a large number of migrants and their families. Elias and his partners decided to counteract the negative influences by providing a safe space for people to gather and participate in community events. This not-for-profit is now one of almost fifty such organizations throughout the continental United States, and belongs to a series of clubs of expatriates that have become more prevalent in the city. Today, more than twelve Mexican states have some form of representation in the area, creating unintended divisions in an already tempestuous and tense environment. Early in their inception, Elias and his partners relied on volunteers, donations, and membership fees for their recreational services. However, now it is a lot harder to sustain their activities due the diminishing volunteer resources and the competition from other non-profits. Therefore, increasingly the organization receives dedicated funds from government agencies in Mexico to provide social services. With the growth, increased accountability and range of activities has come governance challenges. This case study explores those challenges and identifies issues that they raise for the future of this NPO and its leadership.

Elias Gonzalez reflected on the events of the past few days. Things had been tense with other members of the non-profit organization for the past several months, but seemed to have come to a boil in recent weeks. Elias could not understand how things spiraled out of control so rapidly.

It was more than forty years since he decided to move to the United States from his hometown in the state of Guanajuato, Mexico. Poverty made it easy for him to decide to venture in search of a better life. At age nineteen, there was little to hold him back in Mexico. Initially, Elias struggled to find

work and experienced differential treatment as an unauthorized migrant (a person residing in the United States who is not a citizen, permanent resident, or who has been admitted as a temporary resident or worker). He realized that living abroad was rather difficult under those conditions, especially without support from family or friends, in a country where not only the language was different, but the culture and even the food. A group of expatriates, himself included, had organized informally for mutual assistance and to help other Mexican migrants living and moving to this metropolitan area in North Texas.

The area is home to more than 500,000 former Guanajuato residents, largely undocumented and/or from rural areas. Some, through this informal network, organized to celebrate their Mexican heritage, exchange information, and to obtain support. Elias finally could legalize his migratory situation in the U.S. through an amnesty in 1986. Shortly after, Elias began the efforts to formalize the activities of the network. Finally, in the early nineties, Elias acquired the legal documentation that allowed them to operate as a legal not-for-profit organization in the United States and Casa Guanajuato was born.

Casa Guanajuato formally started to celebrate Mexican culture and to promote sports as alternative activities to the neighborhood's bad influences. Since a large number of Mexican migrants live in an impoverished area of the city, social pathologies are prevalent and affect a large number of migrants and their families. Elias and his partners decided to counteract the negative influences by providing a safe space for people to gather and participate in community events.

The not-for-profit is now one of almost fifty such organizations throughout the continental United States, and belongs to a series of clubs of expatriates that have become more prevalent in the city. Today, more than twelve Mexican states have some form of representation in the area, creating unintended divisions in an already tempestuous and tense environment. Early in their inception, Elias and his partners relied on volunteers, donations, and membership fees for their recreational services. However, now it is a lot harder to sustain their activities due the diminishing volunteer resources and the competition from other non-profits.

As a result, Elias decided to enter into a partnership with the state of Guanajuato to serve as an extension office for some governmental services for the state's former residents. This enterprise provides much needed funds, along with legal and professional advice about the activities they conduct. It also has allowed former residents, a large number of which

are undocumented, access to workshops and education that they could not have otherwise. For example, the state provides computers and pays a modest amount to volunteer teachers to help students go through their virtual classes to obtain diplomas that range from elementary school to university studies.

Moreover, every year the state government organizes an event to provide legal documents, assistance, and traditional products from the region to members of the community. Given the migrants' inability to leave the country with ease, it has become a rather popular event; one that has exponentially grown and now serves as an example for the other migrant organizations to emulate. It is in this formal aspect that migrants seem to benefit more than with any other Casa activity. There are other clear advantages of this partnership since the Guanajuato state government recently provided funds to purchase the building used for their daily operations; something that could not have been possible with the previous resource procurement initiatives.

Nonetheless, Elias is not entirely convinced this is all that positive, since before they only had each other to listen to and to keep accountable. Today, it seems there are endless calls, forms, and reports that need to be completed before you can do anything. Keeping track of expenditures, planning activities, and obtaining permits is a herculean task for the original members, since they do not possess formal education of any kind. Long gone are the days of him calling the shots and deciding what to do with little or no interference. Even the unrelated activities, such as memberships for sports, are under scrutiny.

The state government requires them to report on activities and use of resources in order to keep providing funds. In the beginning, Elias made it clear that trust was the most important component of the partnership, and that he, not the members, would ultimately decide the best use for the money provided by the state. After all, there was a reason he had been recognized by the Presidents of both nations on separate occasions for his voluntary efforts. Initially things seemed to work out fine, but lately the requirements seemed to increase almost every week.

Before, his ideas and decisions were put in practice almost immediately. Now, they have bylaws and a "board of directors." People always want to discuss "what is best for the organization," but who better than Elias to know that, when his efforts are what got them where they are? In his opinion, too much time is already wasted writing reports and copying receipts.

Another divisive issue emerged with the increase in potential resources, as people have started to notice and want to share in the decision-making process of allocation. Today, a new generation of volunteers seems to think they know better what to do with Casa. They are younger migrants or the children of migrants that are partially educated or in school. The community benefits provided by Casa has attracted them to volunteer their time and services, and since some of these government processes are too complicated, he reluctantly had to rely on them for some record keeping and accountability activities, as well as teaching and supporting students.

While there is no denying that these volunteers provide valuable services, Elias would prefer if they could just leave the important decisions to him. After all, he was responsible for the regionally recognized boxing program, the cultural festivals, and for finding people to teach English and citizenship classes on site. A few years back he even rented the space as a location to film that famous telenovela, which allowed fixing the place up a bit for free. When have their meetings and reports ever created any real value?

The deteriorating social and economic conditions in Mexico have forced more and more people to move to the United States. Consequently, Texas' immigrant population has increased substantially. Guanajuato is one of the leading states in terms of population mobility, which has created an interest by the government to provide alternatives for the use of remittances. Currently, more than five billion dollars is sent annually to Mexico from Texas alone. As a result, the state supplies economic incentives for migrants to partner with their local communities for the creation of infrastructure projects. The federal government of Mexico also participates by partially subsidizing these programs, resulting in sharing the financial burden in four equal parts (migrants, federal, state and municipal governments).

Underdeveloped communities in Mexico have seen the benefits of these programs as more schools, hospitals, parks, and community centers have been built all over the state, especially in rural areas where the need is most urgent but financial resources are not always available. Is in the managing of these programs that Elias needs the most help, as projects tend to be rather technical or include details that are difficult for him to grasp about legislation, planning for public works, or structures and responsibilities of public financing. As it has become more evident that he is not fully capable of dealing with the most complex issues of this partnership, other board members have begun to question his leadership. Questions have arisen also as some migrants fail to see the benefit of

spending already limited resources outside of their own community. However, since most migrants still have family members or plan to go back to these communities in the future, tensions develop as Casa Guanajuato's role in these projects increases.

Some have gone so far as to call openly for substituting Elias with a new President of the board. He knows in their private conversations most of the new members doubt his ability to understand the intricacies of these programs and to provide the necessary conditions for the sustainability of their activities. As the founder of Casa, Elias is deeply invested in the success and legacy of the organization, but part of him refuses to let go of control. Is it time to move on and leave his life's work in the hands of strangers? Could they continue the work he set out to do all those years ago?

As he ponders the possibilities for the future, Elias realizes that he has not been defeated yet. He still has direct access to the Governor of Guanajuato, and he plans on using this connection to balance the shift in power that has occurred in Casa. After all, it is not the first time he has required political intervention to keep control of the organization. Other governors have made clear that assistance of any kind is contingent upon Elias playing a leadership role in the organization. He does not think this time it will be different. He will take advantage of the governor's visit to remind everyone who is in charge. As Elias walked through Casa's parking lot, into the building across from the boxing ring and the performance stage, he remembered why he did all this. And as he stepped into the meeting room, suddenly he realized what he needed to do.

Discussion Questions:

1. Identify some of the cultural differences that affect the activities and processes at Casa Guanajuato. What would you do to change traditional views of authority and resource allocation?
2. What are the advantages and disadvantages of changing leadership in this case? How would you handle the leadership transition?
3. With growing demands for accountability and reporting responsibilities, what are the desirable characteristics of new leaders?
4. Transnational government programs increase the challenges for program administration, identify some of the salient issues and explain how you would deal with those challenges.
5. What would be your recommendations to institute best practices of good governance at Casa Guanajuato?

BIOGRAPHY

Adrian Velazquez is Assistant Professor of Public Administration in the College of Business and Public Management at the University of La Verne. Dr. Velazquez's research centers on the analysis of immigration policies and phenomena. He is particularly interested in Mexican immigration to the U.S. and the development of immigrants' social networks, as well as factors that contribute to social exclusion. He holds a Ph.D. in Public Affairs from the University of Texas at Dallas, where he also obtained an MPA degree with a Policy Analysis concentration. He has a law degree from Universidad de Guanajuato. His work has appeared in the *Journal of Ethnicity and Criminal Justice*, the *Journal of Intercultural Disciplines*, and the *Journal of Air Transport Management*, among others. In Mexico, Dr. Velazquez worked as Department Manager of Legislative Support in the Water State Commission of Guanajuato. In the U.S., he was a faculty member at the University of Texas at Dallas and at Southern Illinois University – Carbondale before joining the University of La Verne.

Chapter 28

Governance in a Non-Profit Organization, The Case of Sierra Education and Research Institute (SERI)

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Abstract

The non-profit SERI was developed in 2003 with a mission to provide professional, effective, and innovative services with the aid of ongoing research and education for the betterment of the community. The founding Board of Directors worked to establish SERI's vision to develop an all-inclusive wrap-around model of mental health treatment programs for all individuals and families in the community, independent of their socioeconomic status. The organization also provides hands-on skill training for students likely to be working in this type of environment. SERI, with its multiplicity of outcomes and foci poses challenges for governance but the hybrid and inclusive model that has been developed to address those challenges offers an insight into the value of adaptability to unique circumstances.

Introduction

Traditionally, for profit corporate structures have been used as the primary governance structure for non-profit entities, with varied success. However, more recently, some non-profits have begun to adopt more flexible styles of governance, depending on the mission and vision of the non-profit. In this chapter, a more hybrid model of governance will be discussed. This model includes a focus on a shared governance structure. The example used for this hybrid model of governance is a non-profit developed by two professors at different universities, a university administrator, and at the time an undergraduate senior. The current Board includes three professors and one local minister. Since its inception of the non-profit organization, Sierra Education and Research Institute (SERI), it has consistently adopted

a more hybrid model of governance. In this chapter the strengths and weaknesses of such a model will be discussed. In addition, much of this chapter will focus on the perspectives of the doctoral candidates and post-doctoral interns, including their reflections regarding how this model has assisted them in better understanding the governance structure of a non-profit organization. The authors of this article include two founding Board Members, Dr. Jana Price-Sharps and Dr. Amy Tillery, three Post-Doctoral Coordinators, Dr. Stephanie Vucovich-Cholakian, Dr. Lisa Giuliani, and Dr. Rizza Bermio-Gonzalez, and four pre-doctoral interns, Elizabeth Poulsen, Jennifer Roy-Pogutter, Elaine Newborg, and Ben Adam. All of the authors have worked with SERI for at least four years.

The non-profit organization SERI was developed in 2003 with a mission to provide professional, effective, and innovative services with the aid of ongoing research and education for the betterment of the community. The founding Board of Directors worked to establish SERI's vision to develop an all-inclusive wrap-around model of mental health treatment programs for all individuals and families in the community, independent of their socioeconomic status. Through the collaboration of governmental agencies, private organizations, and volunteers, a continuity of care was established, which not only improved individuals' mental health, but overall quality of life. The philosophy guiding the development and maintenance of ongoing organizational effectiveness is continually implementing current research findings to allow services to be provided at the point of greatest impact, thereby increasing positive outcomes.

The SERI Board of Directors is currently comprised of three professors and one local minister. An ad hoc Advisory Board has also recently been developed to provide feedback as SERI expands its services to first responders. The Advisory Board is not part of the governance structure, but has been asked to provide feedback on the development of a highly specialized program. All of the SERI Board Members are involved in different ways with either provision of services, grant writing, project development, or research. The SERI Board is comprised of a President, Secretary/Treasurer, and two other board members. While the pre and post-doctoral students are not on the Board, they all know the Board Members and interact freely with the Board. On occasion the pre-doc or post-doctoral students are asked to make presentations to the Board during quarterly board meetings. This ongoing collaborative relationship between the Board and the graduate students provides unique training for the doctoral students in non-profit leadership.

The three primary goals of SERI is to provide graduate students, enrolled in clinical programs, an opportunity to develop both their clinical and leadership skills; to provide community outreach; and to provide evidence based treatment based on ongoing research. Therefore, a hybrid style of governance has been adopted for several reasons. The shared power and responsibility of governance provides excellent training and mentoring to the doctoral students. This governance style allows SERI to be particularly sensitive and responsive to community needs, allowing SERI to excel at organizational emergence and responsiveness to community change. It also provides a cost effective means of providing excellent services to the community.

As with all governance styles, we have found some areas that are more difficult to address with this flexible style of governance. Some of the areas have been addressed, some are probably more inherent with this style of governance and are therefore more difficult to resolve.

Flexibility, while being an asset, can also be problematic from the standpoint that when new laws are implemented at the State or Federal level, community needs may shift quickly, requiring programmatic changes. SERI has successfully navigated most of the expressed needs of the community. However, funding for these community changes may take additional time and work, which has resulted in some additional funding needs for the non-profit. Recently SERI has started working with a professional grant writer. While doctoral students are still involved in the grant writing process, the grant writer provides the structure needed for successful grant writing projects. Another delicate issue, in a flexible governance structure, is that this structure is based on the inherent assumption that everyone will contribute as needed. Since our core Board Members are very devoted to SERI, we have not had to address this problem. However, with a different composition of a flexible hybrid board, it is conceivable that governance issues may arise from the flexibility and fluid nature of this structure.

The focus of this chapter is how a non-profit can be used as a training and research center for doctoral interns. Graduate programs in general do an excellent job of preparing Master's and Doctoral candidates in their specific field of study. However, rarely do they focus on the business aspects behind the services being provided. Students trained in the physical and social sciences have even fewer opportunities to develop the skills needed to develop small businesses compared to students enrolled in other more business-related programs such as organizational development. This paucity of training may be even more profound in the area of the

non-profit organization. The development of the skills needed to direct a non-profit organization may be best taught through a mentoring process. An integral part of that mentoring process is the development of proficient leadership skills. The focus, as it should be, in graduate school is on the development of specific skill sets, understanding theoretical concepts, and on the different segments involved in the process (e.g. thesis, dissertation, and comprehensive exams). However, once students graduate they may find that they are ill prepared for the professional world. In the fields of clinical or counseling psychology, internships are mandatory.

Unfortunately, interns seldom develop the leadership skills needed to become leaders in their communities during their internships. Unless a student is majoring in business or a related field, the terms, budgets, funding sources, non-profit status, grant writing, and program development are rarely, if ever, mentioned. Students are so focused on the end date (graduation) that they rarely have time to focus on the development of things like community partnerships and networking. Since these concepts are never mentioned nor addressed, students may never learn to think in these terms. In the fields of clinical, forensic clinical or counseling psychology, the emphasis is on assessing and treating individuals and not on how to interact with federal, state, or county systems. One way to educate graduate students of these often novel processes is through a mentoring system in which “senior” graduate students mentor “junior” graduate (and even undergraduate) students. This mentoring may include training, secondary supervisions, and ongoing interactions with senior students. The mentoring process provides the senior doctoral students with opportunities to further develop leadership and mentoring skills, as well as assisting them in solidifying their own knowledge base.

The use of mentoring in higher education has been studied by relatively few theorists. Mentoring has been found to influence a student’s growth in a number of areas. Cosgrove (1986) found that mentoring was directly related to student satisfaction. Mentoring was also found to be directly related to future publishing in academia (Cronan-Hillix, Gensheimer, Cronan, Hillix, & Davidson, 1986). One of the main advantages of mentoring appears to be network and career development (Kemper, 1968; Kram & Isabella, 1985). Mentors may also enhance the talents of their students through the mentoring process, which appears to be directly related to increased self-esteem (Moore 1982). Wright and Wright (1987) suggested that academia may want to take a closer look at the benefits of mentoring and the resulting growth of leadership skills.

Non-profit organizations may require an inordinate amount of patience and dedication. Since a small non-profit organization is typically focused on provision of services, leadership styles may differ from the more traditional for-profit entity where production may be the primary focus. Dansereau, Graen, and Haga's (1975) article discussed changing the paradigm from a supervisory being solely responsible for determining the roles, to allowing some of the members of the team to negotiate roles with the supervisor. In a more recent article, Higgins and Kram (2001) focused on the development of multiple mentors through "developmental networks", or networks in which certain people are identified as being important to career development. In addition to being beneficial for the agency, a coaching style may prove to have additional benefits to mentoring. In a 2006 article by Boyatzis, Smith, and Blaize, the authors encourage leaders to coach their teams with compassion, thereby reducing the inherent stress of leadership while further developing the leadership skills of their subordinates. From their perspective, compassionate mentoring leads to mentally and physically healthier leaders and work sites, encourages organizational health, and increases overall performance.

In his seminal work, Kram (1983) proposed that mentors and their protégés go through distinct stages. Although timelines may differ, these stages can often span across 5-6 years. Healthy progression through these stages results in a redefining of the worker relationships themselves, from unequal and hierarchical relationships in the beginning, to more collegial ones over time. In the model developed by the Sierra Education and Research Institute (SERI), not only are students mentored by a Clinical Director, but they are also mentored by senior graduate students. The focus of this model is to assist doctoral students in the development of the organizational leadership skills needed to manage and expand a non-profit service organization. SERI's program defined six core leadership skills: (1) the ability to think in novel ways, (2) the ability to motivate others, (3) the ability to coordinate organizational services, (4) the ability to develop programs, (5) the ability to implement programs, and (6) the ability to maintain momentum after the initial program was implemented.

To develop these six core leadership skills and to maintain the hybrid model of governance, the Clinical Director and President of the Board provides some of the clinical supervision and training to the doctoral interns. This allows for doctoral and post-doctoral input directly to administration and to the Board. Doctoral students are free to propose new projects or possible funding streams. While not all proposed projects are adopted, the

fluid communication style adopted at SERI allows for a “think tank” sort of project development style. Most training centers are very structured, where interns have little or no input on the governance or vision of the center. While these training centers undoubtedly provide excellent clinical training, doctoral students are not provided with the necessary knowledge of the corporate governance or leadership. The training of clinical interns at SERI includes the routine weekly clinical supervisions. These supervisions include reviews of clinical cases, professional training, and presentations by doctoral students. However, in addition to the general clinical training, students at SERI are also trained on problem solving skills, team building, and mentoring styles. Senior graduate students and post-doctoral students are often involved in conducting training and secondary supervisions as part of their experience. Several senior doctoral students and post-doctoral students have had additional duties as part of their leadership development. These duties have included some management responsibilities under the direct supervision of the Clinical Director. Various positions have been created for the express purpose of providing these future professionals the opportunity to expand their leadership and mentoring skills. This gives post-doctoral students the opportunity to begin to learn more in-depth non-profit management in specific areas like human resources law and guidelines, budget development, management, and advanced grant writing. Since leadership is often a delicate balance between motivating and maintaining accountability of employees (or in this case pre and post-doctoral interns), the creation of leadership positions enables workers to become adept at new skills while receiving ongoing mentoring themselves. Often, available funding for non-profit organizations fluctuates; however, when adequate funding is available it is often used in areas which help further the student’s clinical experiences and for all doctoral students to meet licensure requirements. Since the post-doctoral candidate is not licensed, the clinical supervision continues to be provided by the Clinical Director. The post-doctoral candidate may also continue to accrue additional hours outside the paid post-doc position; these hours may include administrative duties where he or she continues to develop leadership skills and network with community agencies.

Stephanie – Dr. Stephanie Vucovich-Cholakian began working for SERI during her first year of her doctoral program. She has held a number of positions, including Coordinator of our Outpatient Substance Abuse Program. She is currently finishing her post-doctoral internship at SERI as the Coordinator of Adult Services.

A clinician is only as good as the training they receive. So, SERI's standard practice is to pair all student-trainees with more experienced clinicians. This not only ensures that our patients receive quality care, but provides emerging therapists a safe environment in which they learn needed clinical skills. Mentoring diminishes anxiety as responsibility is slowly increased. For example, a senior clinician will join a trainee in their first individual session with a client. In the following sessions the senior observes and oversees the trainee, prepared to step in if questions or problems arise, until the trainee is prepared to conduct sessions alone. This transition allows students to gradually take a more active role as they become more confident and experienced clinicians.

SERI's method of mentoring helps to create an engaging experience for everyone involved. Building on therapeutic skills, steadily increasing responsibility, promoting questioning and personal input, providing regular team building and emphasizing strengths at all levels helps to create "buy-in" for student clinicians. Students take ownership of their positions within SERI and take pride in the services they provide. As doctoral interns we understand that we are not just a body filling a position, but rather a valued team member with something special to offer to our clients and our coworkers. Another integral part of SERI's model of training involves group training. This may include specialized training for specific programs offered by SERI, group supervisions and didactic trainings. In such an atmosphere myself and others involved are allowed to learn from one each other's experiences, as well as listen and give feedback from varying perspectives. Group trainings help to create cohesion within a team and facilitate productive, educational and useful skills.

Lisa – Dr. Lisa Giuliani has also worked with SERI since her first semester of her doctoral program. She is currently a post-doctoral candidate at SERI. She has held a number of positions as part of her internship and post-doctoral training at SERI including the position of Assistant Director and Coordinator of Juvenile Services. Dr. Giuliani is an Adjunct Professor at California State University, Fresno. Dr. Giuliani is also the Coordinator of Juvenile Services at the Juvenile Justice Campus where she provides clinical treatment to juvenile offenders.

Organizational Collaboration

At our county's Juvenile Justice Campus, where I am currently the Juvenile Services Coordinator, we have several collaborations with other support service agencies. SERI provides assessments and mental health

reports for one agency's patients. We also assist with psychological services for an agency that provides mentors to inmates when mentors notice the client's needs are psychological in nature. One of the strengths of SERI is that we can provide services much more cost efficiently than government agencies. These collaborations with community agencies and the opportunity to provide mental health services would not be possible if not for the excellent training, and the wonderful student interns we have at SERI.

The first step in developing community collaborations is to determine exactly what needs are not being fulfilled. Brainstorming with doctoral candidates and post-doctoral interns may include reviewing community resource guides and checking to be sure services are still up to date, holding small community focus groups and asking directly what services are needed in the community. SERI interns and post-doctoral candidates may attend lectures or presentations hosted by other local non-profit agencies. Doctoral candidates should always be encouraged to attend, participate and ask questions at these presentations. At SERI I have had both the experience of a doctoral/post-doctoral intern, and now I am in a coordinator role. As a supervisor, I have found it to be extremely important to assist students in developing networking skills; invite them to meetings or lectures, introduce them to agency contacts, and demonstrate that any type of meeting can be turned into an opportunity to network. Mentoring may include the discussion on the importance of marketing strategies. This includes providing doctoral students, interns, and post-doctoral candidates with business cards, agency brochures, flyers, and a host of other marketing items. It may also include fundamental communication skills such as the importance of direct eye contact, a firm handshake, and a confident manner.

Another way we teach interns to identify a need for a particular service in the community is by making direct contact with other community agencies. Through the direction of the Clinical Director and Post-Doctoral Interns, students are introduced to professionals in the field, and how to find out who the appropriate (decision-making) contact person is at a particular agency. This may also include how to develop and present service proposals. Students may be included in a personal meeting with an agency director, assist in the development of a written proposal, the creation of a power point presentations or fliers geared specifically for the development of a particular partnership. Students are involved in creative marketing strategies in order to present the types of services SERI has to

offer, as well as showcasing the abilities of the doctoral students who will be providing the services. It is also important to teach students what types of services they might be able to provide, what is considered outside the scope of their expertise, and what types of services/collaborations might increase the organization's eligibility for grants, contracts, or other funding.

Elizabeth – Elizabeth Poulsen, M.A. is currently finishing her pre-doctoral internship at SERI. She has been the Research Coordinator and Grant Coordinator for SERI for five years, and is currently a Program Coordinator for a mental health program for probationers.

Ben – Benjamin Adam, M.A. is completing his pre-doctoral internship at SERI. He has held several positions at SERI over the years including Advertising Coordinator, Intensive Outpatient Coordinator and Assistant Coordinator of First Responder Services. He is currently working with individual patients, teens at the Juvenile Justice Campus, and at an outpatient mental health program for adult parolees. He is also adjunct faculty at the School of Criminal Justice at ITT Technical Institute.

Jennifer – Jennifer Roy-Pogutter, M.A. is completing her pre-doctoral internship at SERI. She has also held several positions at SERI over the years. She has assisted in the coordinator of intensive outpatient services, mental health services for a number of different parolee groups, and is currently the Coordinator for Veteran's Services at SERI.

Elaine – Elaine Newborg, M.A. is completing her pre-doctoral internship at SERI. She has held several positions at SERI. She is the Child Services Coordinator, the Coordinator of Juvenile Services at a juvenile hall and bootcamp, and has also worked in our intensive outpatient service program.

Wei – Wei Liao, M.A. is completing his fourth year of doctoral studies. He has held various positions at SERI including Coordinator of outreach programs for the Boys and Girls Club. He has also worked in outpatient services and Veteran's Services while at SERI.

Management Skills through Grant Writing – *Elizabeth*

SERI's grant writing team found many things to be helpful in creating grant proposals. It is beneficial for the grant coordinator to work closely with professional grant writers to help mentor the coordinator through the process. They may benefit from attending a grant writing class or seminar to learn what funders are looking for when awarding funding to organizations. We at the (SERI) have helped facilitate management skills through providing the unique experience of grant writing to our doctoral students – an opportunity not found at for-profit agencies. The grants are

used to pay for clinical supervision, testing materials, office supplies, and other general operating costs. Our grant writing teams generally consist of a grant writing coordinator and a number of doctoral student and professional collaborators with various research and writing backgrounds and experience. Because the grant writing team works collaboratively during the creation process, we have been able to produce a seamless end product. This process also provides the doctoral students with additional team building skills. Moreover, management skills are built through coordination of meetings, meeting deadlines, and reviewing documents. The grant coordinator must work closely with the director of the program to ensure the organization is being accurately represented. Finally, the grant coordinator helps build connections for the organization through attending bidders' meetings, contacting funders, and leading the grant writing team. Grant writing teams should hold weekly meetings to ensure everyone is clear on expectations, understands one another's roles, and meeting deadlines. Finally, when grants are declined, teams should review the comments made by the funders, to review what can be improved for the next application.

Development of Management Skills Through Budget Development – *Jennifer*

Fostering management skills through budget development is an exceptional tool to help doctoral students understand an organization's capabilities and resources. Doctoral students at SERI have helped develop a wide variety of management and professional skills through budget development. These opportunities have allowed our students to gain a sense of the fiscal shortfalls and windfalls our organization faces in its daily operations. Through these opportunities our doctoral students have a realistic understanding of SERI's operating abilities and limitations.

The experiences our doctoral students have gained through budget development and grant writing have been invaluable to their professional development. Doctoral students have participated in a number of challenging projects involving multiple agencies; including one particular project which involved a program spread over three separate counties in Central California. Our liaisons are often required to explain the costs associated with psychological services and the expenses agencies face. One particular challenge we faced with our tri-county project was developing a budget for travel expenses; something we had not previously needed when serving only one county. Students quickly learn that costs and benefits must

always be measured to ensure programs can operate with often limited resources. Travel expenses for our tri-county project were a particularly important component which had to be negotiated with the primary agencies on the grant. While posing a multitude of challenges, this grant provided invaluable experiences for our agency. Because of effective budget development, we had the opportunity to work with other agencies and pool resources in order to serve our clients more efficiently. Like grant writing, budget development is a skill not often available to graduate students in other psychology practicum and internship sites. These experiences offer invaluable real world organizational and leadership skills and should be encouraged in professional training agencies.

Development of Management Skills Through Program Development

– *Elaine and Schuyler*

Elaine – It has been our experience at SERI that the primary goal of program development is filling a need within the community. It is important to conceptualize the type of services that can be provided, and whether or not they will support existing services or fill a void of services that do not yet exist. Through SERI, our doctoral students are encouraged to seek out ways of expanding or creating services. It is important for doctoral students to develop a thorough understanding of the populations to be served and who else may be involved in the provision of services for the program. Some essential information may include: (1) which population the proposal will be developed for, (2) special considerations, (3) other organizations providing services, and (4) who should be contacted prior to providing services.

Networking within the community is an ideal strategy to gain information needed in the beginning phase of program development. Through this process we at SERI learn to ask questions concerning things like available operating space, location availability, and the required contracts associated with the operation. Establishing regular and frequent team meetings in this beginning phase helps to clarify how the program will operate and promote the team's overall understanding of the projects to be implemented. To finalize a new program, with the assistance of the Clinical Director, a Memorandum of Understanding (MOU) is developed and signed. If a doctoral student assists in the development of a new program development, it becomes their responsibility to see either maintain the program or train their replacement in order to provide program stability. Guidance is provided when needed at each phase, but the student is given the unique

opportunity and satisfaction of seeing their vision realized from beginning to end.

Wei – At the Boys and Girls Clubs, doctoral students extended their services to fulfill the need of mentor and counsellor for minors in the community. Networking efforts at this organization sought to expand mental health and support programs to those minors and their families that request it. Furthermore, the goal of these programs was to create a non-threatening environment that underage individuals may turn to for advice and guidance if they lack the resources and capacity to obtain these services elsewhere. The development of the outreach program at the Boys and Girls Clubs clarified the need for such supportive services among the underage population. This was an opportunity to expand SERI's outreach services and enabled doctoral students to gain valuable training in how to further the development of community partnerships.

Rizza – Dr. Rizza Bermio is a post-doctoral intern and Assistant Professor at Fresno Pacific University. Rizza has held several different positions at SERI. Rizza was the manager for the business office at SERI where she was responsible for patient records, invoicing, and other business operations. Rizza completed her pre-doctoral internship at the Juvenile Justice Campus, and plans on completing her post-doctoral internship with SERI.

An effective training institute for doctoral students in a clinical, counseling, or forensic clinical psychology program should be holistic in nature. It should not simply focus on clinical training, but should focus on training in other aspects of professional development as well. Part of this training should be in the area of leadership, since psychologists are likely to end up in leadership positions. Effective training should involve clinical work, report writing, mentorship, and guidance. Effective training should not just allow the doctoral student to observe and occasionally take part in clinical work as their training. One of the most effective components of the non-profit organization that I was trained in was complete immersion.

In my opinion, this is one of the benefits of being trained at a small non-profit organization. As a doctoral student, I was completely immersed into the practices and culture of the organization. I was able to receive close mentorship from not just the Clinical Director of SERI but also from senior interns. Those interns were accustomed to the opportunities available at SERI. At SERI I gained the usual clinical experiences in the areas of individual therapy, group therapy, psycho-educational classes, and clinical report writing; often standard for a training site. However, in addition to these important components of clinical training, I was also exposed to

giving presentations, conducting training, research, grant writing, office management, case management, coordination with other organizations, and community service. Being involved in all of these aspects of the organization in one way or another allowed me to gain experience in a way that I wouldn't have been able to gain at another site in which I would have focused strictly on clinical training. Being involved allowed me to become completely immersed in SERI. Suddenly, I possessed skills I didn't know I was capable of possessing, had the ability to do things I didn't know I could. Suddenly, I was able to speak to a large group of people, and not feel anxiety. I could feel confident about providing my clinical perspective to newer students seeking my advice. Suddenly, I did not doubt my competency as a clinician, or as a leader. As a doctoral intern, I was able to apply these skills on a full-time basis. Part of my role as an intern was as a mentor as well. The leadership skills that I gained helped me immensely in this role. As a full-time pre-doctoral intern, I was fully a part of the program, and thus was able to garner experience as a full-time clinical psychologist. This experience was completely invaluable.

Mentorship is a very significant component of student training as well. It is extremely critical for a doctoral student to have mentors who can provide insight, information, and words of wisdom learned from experience. Without this, the trainee may feel overwhelmed, undertrained, confused, and lacking guidance. This, in my opinion, can also lead to early burnout. I think it is important for a mentor to not only provide guidance from their own experiences, but to show the trainee that they, too, have "been there." Comfort presented in this manner is not necessarily something that can be found in a training manual or in a textbook. The humanity that is essential of clinical work should never be forgotten or neglected, whether it exists within the work itself or within the training provided to those who provide the services.

SERI has been working with undergraduates, practicum students, doctoral interns, and post-doctoral interns for almost ten years. It has both received and lost funding as all agencies have; however, the focus remains: to provide immersion training to students in the development and provision of services through a non-profit organization. The strength of SERI is the training, mentoring, networking, and community relationships it fosters.

Discussion Questions:

1. What are some possible in-service training points on leadership that could be used with such a model?
2. What are some possible problems that may emerge with such a model?
3. How could those problems be addressed as learning objectives?
4. What are possible sources of liability for the non-profit with such a model? How can liability be effectively reduced?
5. What are some ways that the interns and post-doctoral students developed leadership skills with this model?
6. Many of the students in this program started at the non-profit as volunteers and over time became interns and then post-doctoral candidates. What might be the benefits to the students and the community with this model of a training non-profit organization?

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BIOGRAPHY

Dr. Jana Price-Sharps is a licensed psychologist. She specializes in Police Psychology. Dr. Price-Sharps is an Associate Professor in Forensic Psychology at Alliant International University and an Adjunct Professor at California State University. She is the President and Clinical Director of Sierra Education and Research Institute (SERI), a non-profit agency. SERI serves as a training institute for undergraduates and graduate students. SERI provides services to police officers and other first responders and their families. SERI also provides services to under-served populations. Dr. Price-Sharps is also the President of CFI, Inc. CFI provides pre-employment evaluations, polygraph, and background services to law enforcement agencies.

Dr. Amy Tillery graduated in 2007, from Alliant International University, and has specialized in treatment and research of addiction in juvenile and adult forensic populations. She was involved with Sierra Education and Research Institute (SERI) since the inception and continues to serve as the Secretary of the Board of Directors.

Elizabeth Poulsen, M.A. is currently finishing her pre-doctoral internship at SERI. She has been the Research Coordinator and Grant Coordinator for SERI for five years, and is currently a Program Coordinator for a mental health program for probationers.

Lisa Giuliani has also worked with SERI since her first semester of her doctoral program. She is currently a post-doctoral candidate at SERI. She has held a number of positions as part of her internship and post-doctoral training at SERI including the position of Assistant Director and Coordinator of Juvenile Services. Dr. Giuliani is an Adjunct Professor at California State University, Fresno. Dr. Giuliani is also the Coordinator of Juvenile Services at the Juvenile Justice Campus where she provides clinical treatment to juvenile offenders.

BIOGRAPHY

M.Dr. Stephanie Vucovich-Cholakian earned her doctoral degree in Clinical Forensic Psychology from Alliant International University, Fresno. She has been with SERI since 2009, and is currently the Coordinator of Adult Services, while in the process of completing her post-doctoral internship. She specializes in addiction and trauma, specifically PTSD, as well as relationship issues. Dr. Vucovich-Cholakian has worked in a variety of clinical settings including outpatient and intensive outpatient programs, as well as individual, group and couples therapy. Her clients range from adolescents to adults, low to high socio-economic status, students to probationers. Dr. Vucovich-Cholakian has been instructor, therapist, outreach provider and supervisor during her time at SERI.

Jennifer Roy-Pogutter, M.A. is completing her pre-doctoral internship at SERI. She has also held several positions at SERI over the years. She has assisted in the coordinator of intensive outpatient services, mental health services for a number of different parolee groups, and is currently the Coordinator for Veteran's Services at SERI.

Elaine Newborg, M.A. is completing her pre-doctoral internship at SERI. She has held several positions at SERI. She is the Child Services Coordinator, the Coordinator of Juvenile Services at a juvenile hall and bootcamp, and has also worked in the intensive outpatient service program.

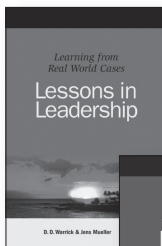
BIOGRAPHY

Benjamin Adam, M.A. is completing his pre-doctoral internship at SERI, in California. He has held several positions at SERI over the years including Advertising Coordinator, Intensive Outpatient Coordinator and Assistant Coordinator of First Responder Services. He is currently working with individual patients, teens at the Juvenile Justice Campus, and at an outpatient mental health program for adult parolees. He is also adjunct faculty at the School of Criminal Justice at ITT Technical Institute.

Wei Liao, M.A. is completing his fourth year of doctoral studies. He has held various positions at SERI including Coordinator of outreach programs for the Boys and Girls Club. He has also worked in outpatient services and Veteran's Services while at SERI.

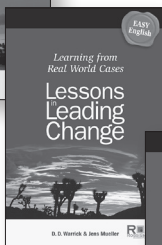
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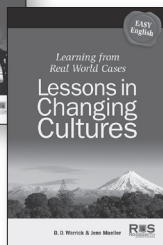
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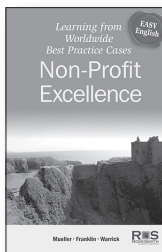
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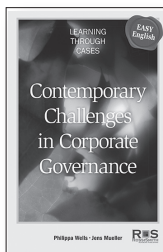
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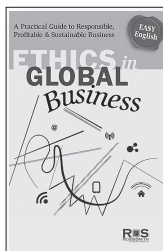
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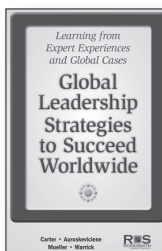
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