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Chapter 1

Corporate Governance

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Additional information is available at the end of the chapter

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Abstract

The following chapter identifies the meaning and main features of corporate governance, underlines the importance of an entity, which regulates and balances the interests of shareholders, stakeholders, and managers in order to realize a corporation's long-run goals. Currently, all models of corporate governance can be divided by their characteristics into three types: Anglo-American, German, and Japanese; each of these models has some unique elements that are required by a particular country. The process of forming and development of corporate governance in transitional economies are described as well. As the accuracy of corporate government influences the wiliness of investors to sink their capital, it is crucial to understand the methods of corporate governance efficiency evaluation by international rating agencies. Moreover, the example of Enron Corporation's failure shows the exceptional role of corporate governance in protecting and ensuring the rights of shareholders and stakeholders, solving the conflict between managers seeking higher bonuses and investors' goals on stable future return and potential growth.

Chapter objectives

- To investigate the nature of conflicts of interest as a precondition of formation of corporate governance.
- To identify the meaning and main principles of corporate governance.
- To study and clarify the key players of corporate governance and their roles.
- To get acquainted with different models of corporate governance and compare their structures and principles of coordination between their elements.
- To specify the features of corporate governance within transition economies and potential limitations on its further development.
- To study the principles and techniques of evaluation the corporate governance efficiency used by international agencies.
- To investigate the failure of Enron's corporate governance.

Methodology

Historical and descriptive methods, including critical review of existing scientific literature, were used to meet the objectives of the chapter; in addition, case study on Enron's corporate governance was introduced. Based on learning the current situation of corporate governance development within advanced and transitional countries, their potential failures and constraints, the crucial contemporary issues were identified and suggested the ways to minimize or eliminate them.

Keywords: corporations, managers, shareholders, stakeholders, corporate governance, conflict of interests, the agency theory, Enron

1. Introduction

Corporations are the key players in the global economic environment; corporations are the main source of a county's economic growth, and the most attractive business deal to invest in. To maintain and increase the profitability of corporations and to enlarge the investments flows, it is crucial to ensure the total understanding of the owners', investors', and managers' interests and to find a way to balance them. All this is about corporate governance and the ways in which investors assure themselves of getting a return on the finance [1]. Corporate governance framework identifies how investors control the manager's actions, how the responsibilities are divided between owners and managers. Adequate system of corporate governance allows the suppliers of finance to relay on managers, to realize that the manager has reliable internal and external sources of information based on which he is able to make rational decisions for their mutual interests.

In general, corporate governance is a complex process that involves organizational, legal, economic, motivational, and social tools, the combination of which provides the unique working environment that allows to minimize costs by reducing the gap between managers' and owners' interests [1]. The well-organized corporate governance is not limited by managers' and owners' goals; it has to include the interests of investors, suppliers, consumers, workers, representatives of a local community, and government officers, as the financial success of a corporation depends on the satisfaction all of its chains.

However, dealing with numerous involved participations leads to a potential conflict of interest; consequently, the key objective of corporate governance is to minimize or eliminate the mentioned conflict.

2. The nature of conflicts of interest

According to the agency theory (see **Figure 1**), an agency relationship can be described as hiring a person (the agent, a manager) to perform and to make decisions on behalf of the principal(s) (owners and shareholders) [2]. The reason why the owner is not operating the business by himself is his wiliness to hire a professional, which will act in the most efficient

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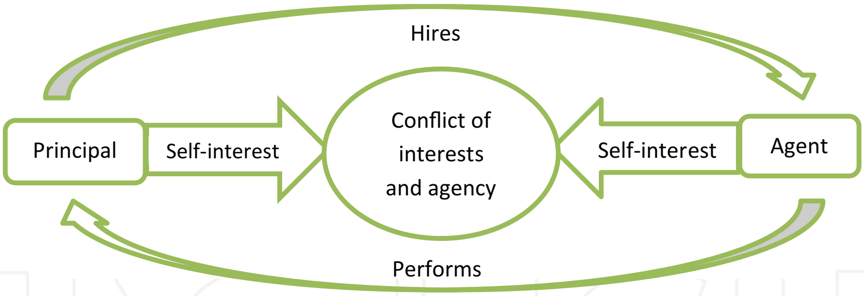

Figure 1. The agency theory.

way to improve the owner's welfare. In practice, this kind of delegation of managing tasks is rational as a manager has more sources of information. Moreover, as the owner and the manager have different information (asymmetric information), the actions made by the manager cannot be fully supported by the owner. If both participants (the owner and the manager) are aiming mostly at their self-interest, there is a possibility that the agent will not act in the best interest of the principal (according to his information).

The principal can limit the willingness of the agent to follow his goals by implementing the appropriate incentives for the agent and monitoring to prevent abnormal activities. Monitoring can be fulfilled in a form of budget constraints, compensation policies, operation rules, etc., and leads to an increase in costs. The bonding costs guarantee that the agent will not make decisions that can harm the principal; otherwise, he will compensate the loss. According to the theory, it is impossible to balance the self-interests of the principal and the agent costless; in each case, positive agency costs will occur, including monitoring, bonding, and residual loss, the last can be described as the difference between the agent's decisions and those decisions that would maximize the principal's benefits [2].

2.1. Discussion

As the agency relationships model is suitable for corporations, it demonstrates the essential need of corporate governance to cope with conflicts of interests. The conflict of interests, as a rule, arises as the goals of shareholders and managers contrast, generally, shareholders seek the stable and ensured return and long-term potential growth, while the aim of managers is to increase the financial performance in the short-time period in order to earn bonuses, which normally depend on the financial results rather than overall stability and reliability. The misuse of the bonus system can lead to either financial or reputational losses, even to "hidden" bankruptcy.

3. Key corporate actors and their roles

Since corporations have more than two involved participants (the principal and the agent), the issues on conflicts of interests, finding, and fulfillment of the mutual goals are more complicated.

There are three key players in a corporation: the board of directors, management, and shareholders. The mission of the board of directors is to select a chief executive officer (CEO), to monitor and evaluate the CEO's performance and planning process, to delegate the responsibilities, and making decisions rights to the CEO. Management directed by the CEO is responsible for setting and following a company's strategy, strategic planning, risk management, and financial reporting to the board. Shareholders supply their finance by buying a corporation's stock and receive some financial return, shareholders do not participate in day-to-day management, but they have a right to elect a representative to the board and to be informed on business decisions [3].

As a rule, corporations have obligations to stakeholders, including employees, suppliers, communities, and environments where a corporation operates, and government. Consequently, the board of directors should know who are their stakeholders, what do they know about business, and what do they expect. Generally, the representatives of management act the role of a spokesman to engage stakeholders, to inform them, to share and examine their proposals on business activities, to invite to meetings, to provide a dialog, etc. Employees are the key capital for any business; fair and proper treatment of stuff is critical for any corporation; it is essential to develop and follow a policy regarding employees' regulation, compensation practices, providing social insurance, etc. Corporations should implement a mechanism for employees to inform managers about possible or occurred misconducts without fearing to be dismissed. In additional, a corporation has to be a good citizen of the local, regional, or national community where the company operates, to be responsible for environment and sustainability of the business that can bring short-run benefits as well as long-run. Being economic, social, and environmentally sustainable encourages new stakeholders to participate and helps to build a "sustainable" image of the company. Corporations, like all citizens, should obey the existing legal rules and regulations, to protect its stakeholders and ensure the further development based on a transparent way of doing business [3].

4. Principles of corporate governance

The term "corporate governance" can be defined in various ways, but still it keeps common characteristics, regarding the implementation of appropriate system of corporate governance to business; it is necessary to follow formal rules and guidance, specifically for emerging and developing economies that only start realization of innovative methods of management. For that reason, some international organizations provided the guidance on corporate governance that identifies the relationship between shareholders and stakeholders, the requirements on transparency and accessibility of information on a corporation's performance, the distribution and interdependence of responsibilities of officers at differ levels of management and other issues on corporate governance [4–6].

Principle #1: Providing the foundation for a corporate governance framework

- To establish the corporate governance framework in accordance with current legal and socioeconomic systems, to ensure and encourage companies to perform transparent and in a social efficient way.

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- To provide a clear division of rights and responsibilities of representatives of the public sector and to avoid double control or contradicting regulations.
- To specify the procedure and mechanism of governmental and public control, and the methods of reporting, informing, and communication to avoid confusion.

Principle #2: The rights of shareholders

- Shareholders have a right to guarantee the methods of ownership protection, transfer their shares, to be informed on the corporation's decisions and performance on a specified basis, to join and vote on the general meetings, elect and dismiss the members of the board, to share in the net profit of a corporation, etc.

Principle #3: The equal treatment of shareholders

- Minority shareholders should be protected from the leading and dominance of controlling shareholders, forcing in a direct or hidden way to vote for their personal interest rather than mutual goals.
- The voting procedure should be explained and clarified clearly to all shareholders, to prevent the misusage of the system.
- Members of the board and key officers should inform the board about any personal benefit that can be obtained from any transaction that affects the performance of a corporation.

Principle #4: The rights of stakeholders

- All stakeholders' rights should be protected by the law; stakeholders should have an access to the information that is required for their performance.
- All stakeholders and their representatives should know the procedure of communication and reporting the board regarding the potential and existing illegal or unethical decisions, rights violation, and other concerns.

Principle #5: Transparency

- Transparency and accessibility should be provided to the information on a company's financial and operational performance and results, key company's goals and interests, major and minor shareholders, voting and selecting policies, potential risks, concerns regarding stakeholders, a corporate governance framework and structure.
- It is required to run an annual audit by an independent and competent auditor to provide the external information on financial efficiency and to ensure that the existing internal reports are reliable and can be used for evaluating future benefits and estimating potential risks.

Principle #6: The responsibilities of the board

- The board should perform in the best interest of the company and shareholders; the board should fairly take into account the interests of all shareholders regardless of the size of their shares.

- The board is responsible for creating, following, and improving, if needed, the corporate strategy, long-terms plans, risk policy, budgeting and financial planning, monitoring and evaluation of the company's performance, overseeing potential emerges, acquisitions, and capital expenditures.
- The board's functions are electing and replacing, guiding and monitoring the CEO activities.
- The board members should identify and eliminate the possible conflict of interest of the board members, top managers, shareholders, and stakeholders as well as issues on misuse of corporate assets.

4.1. Discussion

All the abovementioned principles are required for efficient performance of corporate governance, transparent mechanism of cooperation, and interactions of all participants of corporate governance as shareholders, managers, and stakeholders. At the same time, some issues on implementing those principles can appear in countries with developing or transitional economies, as an uncompleted and still-forming legal system of a country that consists of contradicting rules on corporate governance or even does not include any. As a rule, there are some "gray" gaps (uncertain regulation norms) in the legislation of those countries that are suitable for unfair managers to misuse the current law, that, in turn, makes difficult to develop an efficient corporate governance framework. The solution can be found only in a steady improvement of the legislation in accordance to vital needs of corporations rather than politically beneficial changes.

5. Models of corporate governance

Historical circumstances, social, legal, and economic conditions form a specific model of corporate governance in each country, and those models vary in participants, legal framework, reporting systems, etc. According to some common features, all models can be divided into three types: Anglo-American, German (Western European), and Japanese.

Anglo-American model, called sometimes as an outsider model, is characterized by heavy sparsity of the capital and a tendency to increase in outsider shareholders, which are not connected to the corporation. The model is market-oriented and aiming at the exceptional satisfaction of shareholders' interests. As in an outsider model, there are a huge number of shareholders with tiny shares, and mostly the decisions are made by the manager.

Japanese and German models can be called as insider models, as the ownership rights are distributed among insider participants, which are somehow connected to the corporation, and own relatively big shares. Consequently, the relationships between shareholders are extremely important; the main goal for the insider model is not only to maximize the shareholders' benefit but also to maximize the welfare of other stakeholders.

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However, the existence of different models of corporate governance does not solve the underlying issues on ensuring financial return on investments, the conflict between long-run and short-run interests, between management and directors, between different business strategies of investors, etc.

5.1. Anglo-American model

Anglo-American model is used in the United Kingdom, the United States of America, Canada, Australia, New Zealand, etc., and characterized by the absence of dominant shareholders; the share capital is divided between numerous participants with the average share around 2–5%; consequently, no one can demand the special rights or privileges among shareholders. Additionally, the majority of shares belongs to institutional investors as mutual and pension funds; this type of shareholders plays the role of financial managers, which do not want to be presented in the board and, as a rule, do not take any responsibility for the overall efficiency. The continuous change among shareholders is common for this model, as owning a small share makes the selling process easier, comparing to the owning of a significant share. Thus, the American and English stock markets are well known for their high intensity and liquidity [7–9].

The board of directors' functions are:

1. election of board members,
2. appointment and evaluation of a CEO's activities,
3. evaluation of a current company's strategy,
4. evaluation of financial performance and distribution of its funds,
5. ensuring the legacy of corporation's activities,
6. monitoring the fulfillment of company's obligations, etc.

5.1.1. Discussion

One of the features of the model (see **Figure 2**) is the limited influence of shareholders as they own small shares; they have a right to vote for changes in a corporation's charter, to select and dismiss auditors and directors, which operate the company on behalf of shareholders (owners), to agree strategic decisions as merging and acquisition. Moreover, they do not have a right to select or dismiss a CEO and influence on operating activities of a company.

The existence of the board of directors is a key for this model of corporate governance, as the board is selected by all shareholders and represents the shareholders' interests. As a rule, the board consists of insiders and outsiders; an insider is a person who works in a corporation or connected to management of a company; an outsider is a person or an organization that is not related to a company and invited to provide specific functions; an outsider does not seek any personal benefit.

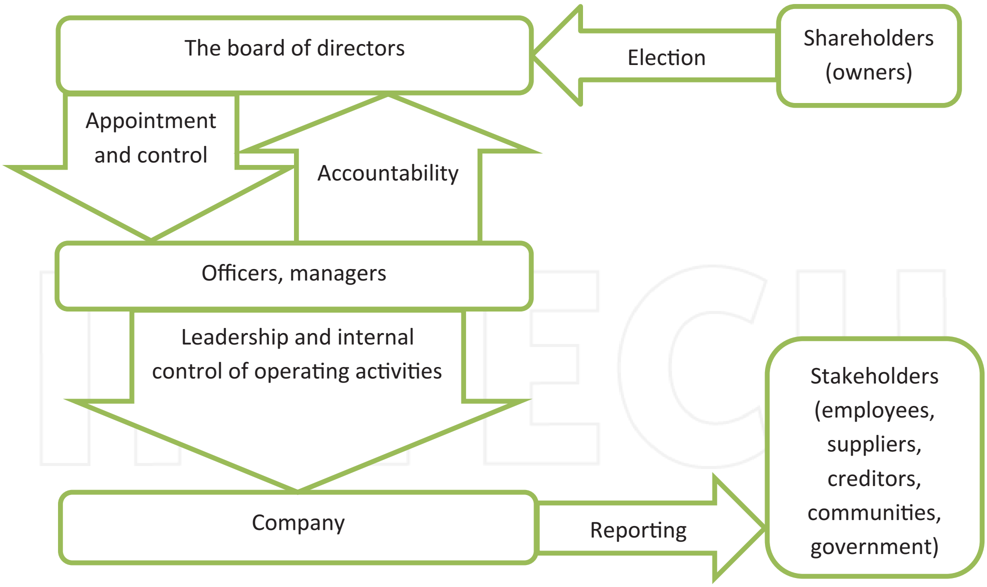

Figure 2. The structure of Anglo-American model of corporate governance.

According to the Anglo-American model, the key role in a company's management is played by the CEO, who makes all decisions on business activities; the CEO even can arrange a committee or committees if needed and appoint members, in addition, it is required to include the CEO in the board of directors.

5.2. German model

German model of corporate governance is used in Germany, Austria, and Switzerland; some elements of this model are used in the Netherlands, Belgium, and France.

The structure of the model is illustrated in **Figure 3**, and specific features of this model are:

1. a corporation's share capital is highly concentrated;
2. a tight relationship between banks and industries, which leads to integration of manufacturers with financial institutions and establishing an industrial and financial conglomerate;
3. banks participate not only by financing projects but also by selecting representatives to perform within the supervisory board;
4. including the representatives from employees and labor unions to the supervisory board;
5. clear division of managing functions into monitoring and operation;
6. existence of two boards, a managing board consisting of managers (insiders) and a supervisory board consisting of representatives of shareholders and employees (insiders and outsiders);

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7. the supervisory board appoints and dismisses the members of the managing board; boards are separated; therefore, to participate in both boards at the same time is forbidden;
8. the managing board independently controls and evaluates the operating activities;
9. the size of the supervisory board is defined by the law and cannot be changed in accordance to the willingness of shareholders; and
10. the restrictions on the possible quantity of votes that can be used by a shareholder in order to limit the influence of a shareholder who owns a big share of a corporation [8, 9].

5.2.1. Discussion

According to German model of corporate governance, shareholders have more rights and responsibilities on distribution of net profit, dividend payments, confirming the decisions made by a supervision board and a managing board, election of supervision board members, and appointment of auditors.

Figure 3. German model of corporate governance.

The legal and social system of Germany modifies the model of corporate governance and emphasizes the essential need to take into account the interests of not only shareholders but also the employees; the ability to represent employees in a supervision board provides better communication and identifies mutual goals. In addition, the share capital, as a rule, is formed by financial institutions rather than by private investments, that shifts the key negotiation process from shareholders to financial institutions. The functions of shareholders, presented in Anglo-American model, are partly transferred to supervision board's functions in German model.

5.3. Japanese model

In Japanese practice of doing business, it is common to form industrial and financial conglomerates, where a big financial institution is combined with an industrial company; consequently, in the structure of corporate governance, the representative of a big financial partner (a bank) is included (see **Figure 4**). A corporation's structure is characterized by a common (industrial and financial) usage of loan and share capital, informal channels of communication and sharing information, and cross shareholdings.

Most Japanese corporations do not involve any outsider board members, as a rule; the board of directors consists of representatives of a company and main shareholders. In addition, the government plays an important role in the management as well; the government is involved in strategic planning and ensures the representation (formal or informal) of its interests in a board of directors. A corporation's goals are formed for the satisfaction of shareholders' needs accompanied with promoting governmental interests. It is crucial for a Japanese model of corporate governance to build up new business connections rather than to balance the interests of shareholders as it was for Anglo-American model [7–9].

According to Japanese model, shareholders are responsible for making divisions on

1. dividend payments,
2. distribution of net profit,
3. election of the board of directors,
4. appointment of auditors,
5. changes to the charter,
6. emerges and acquisitions, a corporation's reorganization,
7. directors' and auditors' benefits, etc.

5.3.1. Discussion

First, Japanese model of corporate governance insures the same direction of all corporations' development as representatives of the government have a right to participate in the board of directors' performance and making decisions process. Second, as corporations in Japan have

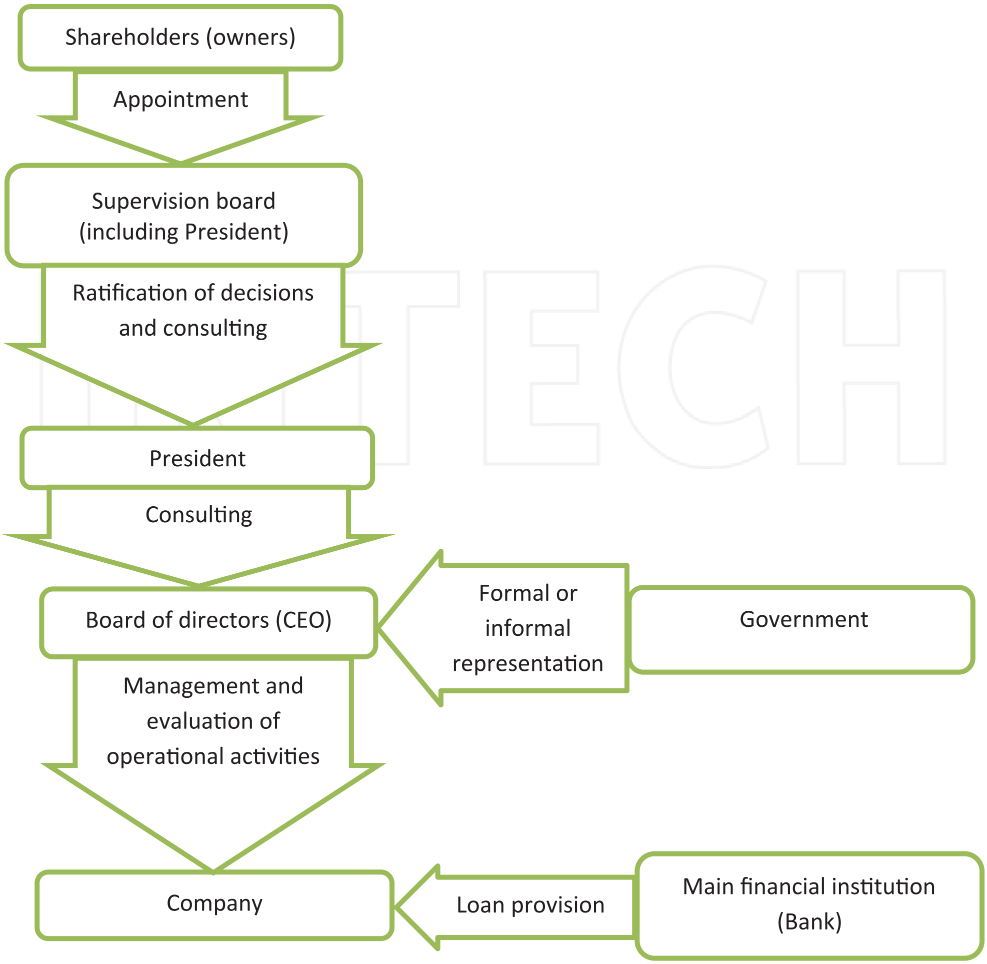

Figure 4. Japanese model of corporate governance.

a form of financial and industrial conglomeration, the representatives of the main financial institution are included to the board of directors and can participate in its performance as well. The mentioned features are the key exceptions of Japanese model in comparison to others.

6. Corporate governance in transitional economies

There is no a specific model of corporate governance within countries with transitional economies; as a rule, the mixture of features of Anglo-American and German models are used. For transitional economies, the key goal is to shift from command to market economy that requires huge investments from the private sector. At the same time, to encourage the investors and to increase the flow of finance to the business and due to the essential need of investors to control and be guaranteed to receive the return, the adequate system of corporate governance should be implemented.

To develop and implement the proper model of corporate governance, the business sector accompanied by the government should solve vital issues of transitional economies. The first one is the absence of the trust in the financial instructions in general and to the investment procedure in particular. As with changing the system of economy, there was a modification in financial sector as well, while with transition, the elements of old and new systems contradict one another that in turn decreases the level of reliability. Weakly developed banking system is not able to play a crucial role in a corporation's performance as an investor and an overseer.

The second one is the privatization of huge public companies, where with public properties inefficient methods of management were transferred to private sector. Under those conditions, there is a complex mission to rearrange the whole understanding of the goals of a company, starting from building up a new strategy of a company till modernization of the bottom level of an organization in combination with launching key functions of corporate governance.

The third one is a changing legislation; with improving market rules, there is a transformation of old norms and regulations to new modern ones. Dealing with changing legal system requires day-to-day updates and forming the system of corporate governance in accordance to it, as one of its functions is to ensure the legislation of a company's performance. Modern models of corporate governance include stakeholders' interests, but in the command system, they were not counted as interested in a corporation's performance, thus they were out of the legislation at all.

The forth one is the lack of trust in shares and corporations with a share capital, that slows down the investment and accumulation of the share capital that is essential for all corporations. The adequate legal system can ensure the rights of shareholders and investors, but for transitional economies, the legislation is under continuous changes.

The fifth one is the superior role of the state, as previously state companies are transferred to private owners, but still the state can participate as a shareholder, and it has unrestricted influence on a corporation's performance based on the previous ownership. In such corporations, the state, as a rule, forces shareholders to make decisions that are beneficial for itself and then for other shareholders and stakeholders. At the same time, there can be even cases on violation of property rights and misuse of corporate governance functions in order to meet needs of state shareholders [8].

6.1. Discussion

The current issues on corporate governance implementation in transitional economies require the development of specific principles of building up a reliable and suitable system of corporate governance based on real transformations and incomplete legislation, as the norms appropriate for successful performance in advanced countries cannot be fully used in transitional economies. The gap between principles of efficient corporate governance published by international organizations and suitable principles for transitional economies allows managers and shareholders to misuse them in favor with their personal interest.

7. The evaluation of corporate governance

As an investor's goal is to ensure the future return and benefits, to realize their interests, as a rule, they sink their capital in well-governed corporations, which operate in accordance with the current legislation and guarantee the fair participation of investors in the decision-making procedure, are able to eliminate the risks and balance the interests of shareholders, managers, and stakeholders. The level of corporate governance effectiveness can be measured by using the methodology of rating agencies, by evaluating the actions of key participants as well as the financial outcomes.

The first agency that implemented the rating system on corporate governance is Standard & Poor's, which evaluates the efficiency of corporate governance by studying the following actions: the misuse of a corporation's resources by the dominants for the satisfaction of personal interests, the structure of bonus systems that can encourage managers to achieve the short-run benefits instead of following long-run priorities, and inappropriate control of information that can lead to the asymmetric access to the information, accompanied by an increasing gap between interests of shareholders and stakeholders.

The rating reports provide the information on a corporation's financial and managerial performance due to the investors' need to understand and evaluate in advance the potential benefits of financing a specific corporation based on the rating criteria, which in turn form the perception of a company, its image and ability to create value, weak and strong sides of its corporate structure and functions, comparative advantages, etc., in general, the place among competitors. The availability of an objective, nonbiased, and reliable evaluation methodology allow to eliminate the asymmetry of information between shareholders, managers, and stakeholders, that, in turn, increases the probability of implementation of common interests and gaining the higher return of invested financial resources.

The corporate governance score, evaluated by the agency, provides the experts' opinion on the principles of existing structure of corporate governance and the efficiency of implementing the declared principles in comparison with other corporations. The score is calculated based on the detailed analysis of a corporation's reports and official documents and interviews with top managers. There are four key criteria of overall evaluation (for more information see **Table 1**):

1. The ownership structure, which consists of the information on the shareholders, their interrelations with stakeholders, and influence on a company's performance.
2. The legal framework, which indicates the level of legislation protection of shareholders' and stakeholders' interests. In cases with a weak legal system, regardless the wiliness of

shareholders and mangers to improve the structure of corporate governance, the indicator will remain low, limiting or preventing any further elimination of risks and dealing with a conflict of interests.

3. Transparency in actions, which shows the level of information accessibility and openness of a decision-making procedure; a principle of regular reporting provides an overall understanding of financial results, current and potential risks, and growing possibilities, in addition, it offers the symmetric access of information to shareholders, managers, and stakeholders that ensures the rationality of managers' decisions on the operating stage.
4. The structure of the board, which illustrates the level of independence of the participants separately and the board as an entity, the functions of the board and the efficiency of their implementation, the form of interactions between lenders, managers, and stakeholders, the system of compensation [10, 11].

To meet the demand of financial institutions and private investors for reliable evaluation of a corporation's governance and the level of protection of shareholders' rights, a well-known organization, Moody's, provides evaluation reports on the efficiency of corporate governance. Moody's (see **Table 1**) empathizes the crucial influence of corporate governance on financial or credit risks.

Criteria	Moody's	Fitch	S&P
Board independence	x	x	x
Director quality and diversity	x	x	x
Internal control (audit)	x	x	x
Ethical policies and processes	x		
Directors and managers conflict of interests	x		
Interest balancing policies	x		
Shareholders' rights (voting rights)	x		x
Governance transparency	x		x
Mechanisms or policies for transaction supervising		x	
The performance-based compensation linked to the company's long-term growth		x	
Potentially market expectations for the company's earnings growth		x	
Transparency of ownership structure			x
The concentration and influence of ownership and external stakeholders			x
Transparency and disclosure of information			x

Table 1. The common and specific criteria of corporate governance efficiency evaluation.

Moody's defines five key positions based on which the overall estimation on corporate governance can be completed [12]:

1. the effectiveness and independence of the board of directors;
2. the adequate compensation system for managers and directors;
3. the regular information disclosure of main financial reports to creditors and investors; implementing internal control in a form of an audit committee in order to provide reliable information on financial performance;
4. the ownership structure and characteristics regarding investors and creditors;
5. the ensuring and protection of shareholders' rights, especially minority ones, to vote, participate in the decision-making, etc.

The Fitch rating report is another case on estimation the efficiency of corporate governance; the goal of this rating system is to ensure the interests of creditors and shareholders by valuing the influence of corporate governance on possible credit risks. According to Fitch (see **Table 1**), the crucial elements of corporate governance for ensuring the interests of shareholders are the following:

1. the independence of the board of directors that includes the clear procedure of nominating directors, the wiliness and ability of managers to understand and follow a corporation's strategy;
2. interactions between different parties, minorities, and dominants in accordance with the existing policies of supervising negotiations and balancing the interests;
3. proper system of internal control, as a rule, provided by an audit committee, on potential risks and reliability of financial reports;
4. Compensation system that takes into account the current financial situation of a corporation as well as the importance of long-run stability and competitiveness rather than short-run benefits; and
5. capital structure, which demonstrates the shares owned by the executive [13].

7.1. Discussion

Based on the previous study, it is crucial to identify the common and specific criteria (see **Table 1**) that are used to evaluate the efficiency of corporate governance by different agencies, in order to improve the efficiency and to decrease the potential risks its crucial to ensure the transparency of financial and managerial performance, to disclosure regularly the information required by shareholders and creditors in order to plan their future finance and understand the overall financial situation.

The transactions and potential interdependence between shareholders and managers should be regulated by the existing legislation and internal policies regarding balancing the interests of shareholders, creditors, managers, and stakeholders, supervision of negotiations, and adopting the system of compensation in accordance to the strategic long-term goals rather than short-term benefits. An improvement in corporate governance can be considered as a comparative advantage, which attracts new investments and can be an excellent foundation for further growth of a corporation; from the point of view of creditors and shareholders, appropriate governance eliminates and minimizes possible risks and ensures the future return.

8. A corporate governance failure

The biggest scandal of twenty-first century is the case of Enron corporate governance failure. Enron Corporation was established in 1986 as a pipelines company from the merger of Houston Natural Gas and InterNorth. In the procedure of the emerge, Enron gained a huge debt and, according to the legislation, lost all rights regarding its pipelines. It was a financial disaster, and a new innovated strategy was required to survive and accumulate capital, financial inflows. The owner engaged McKinsey & Co (a young consultant named Jeffrey Skilling was assigned to the issue) to develop a new strategy and the outstanding strategy was found. According to the new strategy, a Gas Bank should be set up, which would be used by buyers and sellers of natural gas, at the same time, Enron would be involved as an intermediary, which guaranteed reliability and predictability regarding pricing and delivery for both parties. By the beginning of 1990s, Enron was transformed into a major gas trading operation and established a new division called Enron Finance Corp., which became a leader of the market for natural gas contacts dealing with more suppliers and customers comparing to its competitors [14, 15].

Skilling transformed the corporation culture to suit its new trading strategy; he decided to hire the brightest and most perspective traders; in exchange for overworking, he provided some additional services like a company gym and corporate perks, besides that, they suggested a bonus system on a merit base.

With a growth of external power of a corporation, there was a slight degradation of the internal culture; skilling launched a tough employee-ranking system, based on the values of Enron: respect, integrity, communication, and excellence; however, the key measure of a performance was the amount of profit they can produce. With the implementation of the new evaluation system, the turnover of employees grew up to 15% annually, and under those conditions, the priority moved from long-run goals to current increase in the profit and new contracts signed.

In 1996, Skilling as a chief operating officer suggested to use the gas bank model in the market for electric energy as well. In 1997, Enron acquired electric utility company Portland General Electric Corp. and named it as Enron Capital and Trade Resources, by the end of the year, the division transformed into the nation's largest wholesale buyer and seller of natural gas and electricity, by that time revenue increased from $2 to $7 billion with employees from 200 to 2000.

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The most financially significant was a creation of Enron Online in 1999, an electronic commodities trading web site. Enron was counterparty to every transaction conducted on the platform; besides that, Enron was either a buyer or a seller in each transaction, and its credit was crucial to provide safe and reliable environment for energy industry. Enron Online shortly reached an incredible success with $335 billion in online commodity trades in 2000. In August 2000, Enron's stock reached its maximum of $90.56 and the company was recognized as one of the most admired and innovative in the world by Fortune and other publications [15].

Meanwhile, in the beginning of 2001, the energy prices began to fall and the world economy got in the recession, thus Enron's profitably sharply reduced, specifically the finance division, where contracts were signed regardless the possible future risks. As investments inflows are related to a company's estimated risk, representatives of Enron started to influence credit rating agencies as Moody's and Standard & Poor's on improving the credit ranking. There were other ways of reducing its financial debts as a reduction in hard assets accompanied by increasing paper profits in order to increase the return of assets and lower the debt-to-total-assets ratio, making a company more attractive for investors. Another way to hide the real financial situation was to use a limited partnership with an outsider partner ["special purpose entities" (SPEs)], the company provides hard assets and related debt to an SPE in exchange for an interest, then an SPE is able to borrow huge amounts of money from financial institutions to purchase assets or conduct other business; in this case, the debt or assets would not be shown on the company's financial documents. Thus, Enron used thousands of SPE to hide its debts and modify its financial reports as well as to maintain a share price.

As a result of accumulation of debts and failures in launched projects, the price of an Enron share fell to $60 and continued to fall. In October 2001, Enron announced about $591 million in losses and an additional $628 million in liabilities. The equity market reacted immediately, and a share price became less than $10. On November 30, the stock closed at 26 cents a share and, on December 2, Enron announced about its bankruptcy [14].

8.1. Discussion

The case of Enron raised up a question on some of the key functions of corporate governance as the adequate disclosure practice and the integrity of the independent audit. In the manner of Enron's management, the following risk factors can be seen :

- aggressive earning targets and a merit-based management bonus compensation system;
- extreme managements' interests in keeping stock price and earning targets;
- failure in accumulation of financial inflows from operations while publicly reporting earnings growth; and
- substantial associated party involvement and transactions.

Enron's case started the era of global mistrust between investors and corporations, the general belief that the American companies have the most transparent and fair way of doing business disappeared. Shortly after Enron, another American corporation WorldCom announced about its bankruptcy, which made even bigger the gap between managers' and investors' goals and ruined the reputation of fast-growing corporations. These failures taught a good lesson for businesses; internal stimulation methods as bonus systems do not guarantee the long-term growth and stability, the participation of state and public participants (stakeholders) are crucial in appropriate corporate governance, which ensures and protects the rights of shareholders.

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Chapter 2

Corporate Governance and Fraud: Evolution and Considerations

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Additional information is available at the end of the chapter

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Abstract

There are many definitions of Corporate Governance, as a structure, as process, as policies, as mechanisms, but despite their differences of focus, they mainly addressed the sustainable economic growth and protection of shareholders and other stakeholder's rights. The purpose here is to present the evolution of the main principles and frameworks as corporate and financial environment changes and set new challenges. Some important scandals that revealed the weaknesses of corporate governance frameworks are described to complement the comprehension of the object of it. It is detached the aspects simulated or ignored and the subsequent enforcement and monitoring response. Discussion about the new challenges, what corporate governance is supposed to provide and what it can promote, closes this chapter.

Keywords: corporate governance, corporate fraud, scandals, monitoring control, enforcement

1. Introduction

The purpose of this chapter is to present the evolution of main corporate governance principles and frameworks, but not exclusively. As corporate governance effectiveness also depends on legal, regulatory and institutional environment, some important changes within this environment should be pointed out to better address the challenge behind the central issue: reassure shareholders and other stakeholders that their rights are being protected.

The growing complexity of businesses increased the desire to access management processes by standardized procedures. In this context, the Organization for Economic Co-operation and Development (OECD) published *The Principles of Corporate Governance* in 1999 [1]. The objective was to help policy-makers evaluate and improve the legal, regulatory, and institutional framework for corporate governance, with a view to support economic efficiency, sustainable growth and financial stability. Since then, the principles have been adopted worldwide as an international benchmarking for policy-makers and stakeholders.

Corporate governance has been defined as a set of mechanisms of incentives and monitoring in order to assure a good management in behalf of company and its shareholders and others stakeholders. It should build an environment of trust, transparency and accountability for investments. Nevertheless, despite the improvement on business environment, some events periodically show that these principles are overlooked by important companies or even simulated.

After big corporate scandals like Enron, WorldCom, Tyco, Parmalat, the quality of financial statements and the role of auditors and accountants were broadly questioned and turned to be the central point in corporate governance issue for some couple of years. As a matter of fact, corporate scandals open wide weaknesses on internal and external controls over companies, which should be detected by good practices of governance. Effective corporate governance should reduce the likelihood of creative accounting and frauds.

Sarbanes-Oxley Act of 2002 approved by American Congress was a response to these scandals as a temptation to restore investor confidence by ensuring compliance. Effectively, it ended with a century of self-regulation of the accounting profession in the USA [2, 3]. Section 404 of this law requires extensive documentation, tests and assessments of companies' internal-control procedures. Corporate Governance framework has shown to be ineffective to avoid or to preview financial misstatement. SOX was then supposed to allow detecting problems on financial reporting processes and procedures before scandals.

The SOX Act created the Public Company Accounting Oversight Board (PCAOB) with the mission to oversee the audits of public companies and related matters, even in foreign companies as they were listed on U.S. stock exchange market. It was given authority to inspect accounting firms work, conduct investigations and take disciplinary actions. After an initial constraint, European Commission (EC) rules started to incorporate part of Sarbanes-Oxley Act to remodel Corporate Governance standard within European Union. Self-regulation market approach was no longer efficient to assure corporate governance even in Europe.

PCAOB issued a standard that requires notation about any significant defects or noncompliance in audit testing work. Many others procedures were imposed to auditors to ensure the quality of their assessment of internal controls like increasing disclosure requirements, disciplinary sanctions and effective independence.

Improvements led up to a largely movement–but not smooth, to broad adoption of international standards on accounting (IFRS, IPSAS) and on auditing (ISA). Even on corporate governance, EC concluded that European Union should adopt a few common essential rules. We should also point out the collaboration between two important securities market regulators (SEC in USA and CESR–Committee of European Securities Regulators) in order to enhance dialogue and prior detect emerging risks and problems as potential regulation to avoid them.

Corporate governance mechanisms continued to be improved. For instance, as institutional investor (mutual and pension fund) became important players in the majority of financial markets, more attention was given to their participation and interaction with corporate governance [4].

Despite this engagement after 2000 scandals, a new crisis based on accounting frauds astonished the world. Bank failures and financial crisis of 2008–2009 brought out a new type of governance failure: on a system [4]. An entire sector including its regulatory agencies decided to let it on.

Corporate governance pos-2008 addressed some more issues: recommendations for improvements in remuneration, risk management, board practices and the exercise of shareholder rights. The latest revision of the principles was conducted in 2015 at G20 Forum [5]. The revision was necessary to incorporate changes in both the corporate and the financial sectors.

Financial shenanigans and accounting frauds will never be avoided completely. When regulation is improved, by enforcement or incentives, another creative fraud will be designed. Corporate governance can help companies avoid biased decisions that could take them out of a sustainable trajectory but will not assure an ethic performance, at least, not alone. It is always important to consider incoherencies among business or market information, for a single company or for a system as a whole.

2. Corporate governance origins

Historically, accounting frameworks and concepts have been developed in order to support transactions necessity. When simple exchanges were predominant, inputs and outputs control were the main framework, registering what was being receiving in exchange. Under mercantilism capital system, the necessity of controlling the assets promoted the development of the main current accounting structure. Continuing the evolution, as industrial capital required management accounting frameworks to control production, financial capital promoted the separation of ownership from management and required a broader control over accounting information. Since then, capital market has been setting challenges to accounting and governance frameworks.

To reduce agency conflict [6], corporate governance issue emerged as a mechanism of monitoring and control for assuring that shareholder's interests would be pursued. Shareholders disposal financial resources to be invested with a purpose and managers have to disclosure accountability, assuring that resources have been used as expected. Despite this discussion in the literature, the term *corporate governance* strongly appeared as a reference only in 1990s [7, 8].

It is important to point out that financial information is the main report analyzed by shareholders and stakeholders to evaluate the level of accountability and governance. So problems related to the manipulation of this information are also present on governance and they occur on society since much earlier than the separation of ownership and control [9]. Practices to deceive someone else are similar. What bursts the effect of them is the fact that manager can do it without allowance of ownerships and many people can be affected, as operation scales of companies became larger and spread in a globalized world.

Creative accounting has been used for many purposes as to avoid taxation, to issue new shares, to distribute more dividends, etc. (e.g. [10]). Many authors studied the motivation for it (e.g. [11]), but it is not the focus here. In synthesis, creative accounting has been used to hide poor performance or failure, to boost the economic performance or to perpetrate a corporate fraud over investors [9].

When industrial revolution created companies big enough to require investment from diverse sources and could not be managed by their owners anymore, two main mechanisms were developed to mitigate the agency conflicts: the executives compensation plan and boards monitoring role. Compensation and bonus plans started to be developed as a rational way to pay managers for working in the best interest of owners. The outcomes-based incentives turned to be an important mechanism used by firms to align interests between agents and principles [12, 13].

When economy is in expansion phase, it is more difficult to pay attention to red flags. But financial crises play an important role to improvements on corporate control. The next sections were separated by main financial crises that promoted a worldwide injures and changes on governance.

It is worth to point out that although the same problems have been occurred in all parts of the world, many events commented here were placed in the United States, as its consequences affect a great number of people and markets and usually drive the main changes on legislation, enforcements and practices worldwide.

3. From 1929 crisis up to 1970s

The 1929 crisis turned explicit some problems that were being overlooked by investors and shareholders. It showed that capital market was developed enough to receive more attention by government authorities. During the 1920s, millions of people invested their fortunes in stock market and lost great part of it. Public have lost confidence on capital market and by this time, it constituted an important financial source for economy. It was urgent to restore investor confidence on it [14].

In 1932, the first big corporate scandal was Kreuger & Toll, the king of matches that used subsidiaries transfers to avoid taxes and diffuse the lack of asset given as collateral for multiple loans, exceeding the credit limit. Discovered after Kreuger death, this scandal attracted press and U.S. Congress interests. Something should be done regarding securities, corporate structure, accounting and auditing [9, 15].

By 1933, it was approved the Securities Act that required that investors should receive true financial information and prohibit fraud, indicating civil liabilities and penalties to false communication [16]. To empower this Act, by 1934, it was created the Securities and Exchange Commission—SEC [17], providing regulation and control over transactions in securities, as they constitute a national public interest. Besides the law, 1934 Act created a regulatory authority that required periodical information and had disciplinary powers over companies registered there.

One of the SEC first requirements was for disclosure of executive pay. In 1929, private information about the excessive salary and bonus of Bethlehem Steel president came to public and outraged them. Both were substantial higher than a management compensation considered good on that moment. This kind of incentive became a public interest since then [13].

In order to avoid unrealistic bonuses, many firms adopted performance-based compensations. This mechanism should avoid paying high bonuses when things are going bad. It is supposed to avoid moral hazard [6]. The principal wants to expend as little money as possible and get as much effort as he can from agents. Agents want to expend as little effort as possible for getting as much money as they can. Performance-based incentives would align these opposed interests. Notwithstanding, this performance-based incentives shifted the risk from shareholders to managers. Their perception of compensation risk (and personal wealth) led to the intensification of earning manipulation practices [12, 18, 19], or at least induced dysfunctional results, as this perception also depends on measurement systems covering and the level of supervision control [20]. Managers misrepresented financial reports in order to inflate company stock prices and other compensation-related metrics [21].

As capital market turned complex, other laws were being approved like ones to regulate debt securities (1939), investment companies and investment advisory (1940) [14]. All these laws can be seen as adaptation to market environment but one of them deserves a commentary.

In 1940s, a graduated income tax structured was implemented in the USA and affected mainly the senior executives. To avoid it, many others non-cash compensation was developed, as deferred compensation and stock options [13]. In 1950, the Revenue Act allowed that income tax would be applied over gains when shares were sold, creating the figure of restricted stock options. The era of compensation has started. Despite other tax code changes along time, this kind of compensation continued to be used. Stock-based compensation is consistent to agency theory and was seen as a governance mechanism to discourage misrepresentation [19]. Empirical studies, however, present different evidences that testify this hypothesis (e.g. [22]) and that refute it for some types of stocks (e.g. [12]).

Economy was growing in the 1960s thanks to a huge explosion in technology, and executives were willing to participate in this. Stock options were then the main instrument used to do it, but Senator Albert Gore started a campaign to eliminate the tax advantage of them. In 1970s, there was a stagnant economy in function of oil crisis and unemployment. In this context, restricted stock became more popular as share was to be paid out over three to five years depending on financial performance or other goals. At this time, options were not seen as a motivation for short-term performance and main as a retirement and long-term saving plans [13].

Although accounting for options had been raised on 1950s as the use of this instrument was intensified, the first accounting rule about it was only issued in 1972. The APB n° 25 was an opinion issued by the predecessor of Financial Accounting Standard Board (FASB)—the Accounting Principles Board (APB). This opinion specified the intrinsic value method for valuing stock options (quoted market prices—exercise price), and this net value should be expensed. As companies made the exercise price equal to the quoted market price, the intrinsic value was zero, and it seemed that APB n° 25 did not require options to be expensed [23–25] and so was mere figurative enforcement.

In 1973, it was founded the Chicago Board Options Exchange (CBOE) and stock options started to be negotiated in a more regulated basis. At the same time, it was published the Black-Scholes method for valuing options [26], which turned to be the most widely used model. Despite a more precise method for valuing options, they were not yet recognized by accounting rules and were not registered.

In 1976, Congress finally repealed the 1950 rule that had sheltered stock options from tax [24].

4. 1980s and 1990s: folly in organization level

These two decades are here detached from prior period as the corporation and legal environments suffered huge changes that led to spectacular level of executive remuneration and lack of control culminating in big scandals in 2000s—the next section. Different from prior section that started from a financial crisis and its consequences on governance, this section describes the main facts and movements important to understand the next financial crisis.

When the new economy expansion took place in 1980s and 1990s, stock options and restricted stock were intensively used and started to represent mega grants [13]. Stock options were not seen as a tax-avoidance vehicle anymore as in the 1960s and 1970s but as a way to get very rich quickly.

By this time, CEOs turned to be celebrities, *stars*, mainly in function of their millionaire compensation and publicity over it [13, 27]. If in 1929, an excessive payment outraged public, in 1990s, it enacted competency and talent. Media played an important role on this new discourse, publishing executive pay rankings and miraculous executive histories, creating myths [28].

It is supposed that with options, executives would be compensated only if shareholders also gained. The main problem was that the focus was shifted from company's operation to stock performance, considered the ultimate measure of a good corporation management [13]. As markets are not efficient as in theory, the stock price depends on variables others than long-run profitability of firm, and then, stock options would force manager to focus on even shorter run goal of raising stock price [29].

And if managers were too worried about stock performance, creative accounting would be useful to help them to sustain stock price. Many misrepresentations of financial statements (cooked numbers) and even frauds were perpetrated in name of such objective [9, 21]. Another usual managerial tool during this period was the challenging goals set linked to executive compensation plans. As some authors identified a good linkage between difficult goals with good performance (e.g. [30]), some others identified a linkage with cooked numbers (e.g. [31]) and unethical behavior (e.g. [32]). Anyway, unmet goals linked to compensation plan in this context amplify the perverse consequence.

After a wave of diversification of businesses and vertical growing, along the 1980s great corporations started to refocus on core business. Leverage buyouts (LBOs) and management buyouts (MBO) became popular means by which managers turned owners of split companies, intensifying the stock ownership among executives. Two factors seemed to be important to explain preferences for stock options: (a) it was not necessary to pay for shares and (b) there was a fiscal benefit. [13].

An Internal Revenue Code Section approved in 1994 restricted excessive salaries packages to executives but exempted stock options from tax deductions limit. This exception was for performance-based remuneration preapproved by board formed by external directors [13, 33, 34]. Actually, the Section 162 m of this Code provided an environment to flourish two tendencies on governance instrumentals: (a) increasing of stock options on compensation plan and (b) board with outside directors.

It is worth to point out the role of high technology phenomenon of 1990s on governance changes forthcomings. Different from general industries where only executives were compensated with stock options, in high technology companies, every entry-level employee received them. An institutional study certified that biotechnology and computer companies granted 55% of stock options to non-management employees, from 1992 to 1997 [22]. Microsoft, Intel and Cisco Systems were examples of companies that granted stock options to all employees. It illustrates the importance of this industry on lobbies against regulation [13].

Boards were supposed to establish and monitor executive compensation plans and corporate strategy. Experiences (and scandals in 2000s) along these two decades showed that there was a lack of board independence (e.g. [35–38]), there was rudimentary instrumental or lack of competence to evaluate compensation plans and financial reports [13, 21, 37, 39], and as almost a consequence, a simulacrum of monitoring as board members acted as members of other boards acted, maintaining the status quo [13]. This reinforcing mechanism was expected, as Board members were also CEOs in other companies. Consultants should help but there was also a lack of independence of consulting firms. Many of them were also auditing or have closely relationship with management [13, 23, 29].

This problem of monitoring gets worst and more complex as at this time, there was no accounting measurement for stock options yet. If it was not registered in accounting reports, their cost was unknown by managers as also by board and investors. There was a legally hidden cost. Now, it is worthy to take a deeper look over this discussion.

In the early 1980s, the responsibility for setting accounting standards has migrated from American Institute of Certified Public Accountants (AICPA) to Financial Accounting Standards Board (FASB), dominated by accounting firms, some Wall Street analysts and corporate executives. Differently from Accounting Principles Board—APB, it will have full-time employee dedicated to the complex accounting issues [13, 15]. This movement had already occurred in UK after an accounting scandal related to a takeover. The intense repercussion on press led to the creation of the Accounting Standards Steering Committee in 1970 in order to develop and publish mandatory UK standards [9].

Since its creation, FASB began a campaign to require the expensing of stock options, fuelled by investors outrage over excessive executive pay. In 1993, they had prepared the SFAS n° 123 requiring expensing. Opposition was visceral. Companies that used stock options intensively (large companies in general industry and high-tech companies), if expensed its costs, would see the earnings and stock price drop. There was an intense lobby made by CEOs, corporations and also auditing firms. These great companies were important clients of auditing firms. Andersen was taken as a serious accounting firm until then but had a good portion of clients from high tech industry and actively acted against the FASB proposal [13, 15, 24]. The final bullet to kill the FASB proposal was done by North American Congress. They voted a resolution urging that FASB not to issue the statement (SFAS n° 123) obliging expensing stock options. It was a political threat to the independence of FASB as standard setting. This status could be revoked.

The solution found by FASB members was to issue SFAS n° 123 in 1995 saying that options *could be* expensed instead of *should be*. And for companies that chose not to expense, there was an obligation to disclosure them on footnotes. SFAS n° 123 also indicated that options could be valued by fair value method instead of intrinsic one, as Black-Scholes was a popular means to do it. Companies did not accept this recommendation and continued to value options by its intrinsic value (actually, zero) as APB n° 25 indicated [25].

Within this context of increasing financial misrepresentation, some principles of corporate governance and frameworks that support it started to be developed around the world. Two majors concerns besides corporate governance were internal controls and information systems. Two frameworks were developed and adopted worldwide by auditors to attend to these concerns: COSO and COBIT.

The National Commission on Fraudulent Financial Reporting, an initiative sponsored by the American Accounting Association (AAA), the American Institute of Certified Public Accountants (AICPA), Financial Executives International (FEI), The Institute of Internal Auditors (IIA), and the National Association of Accountants (now the Institute of Management Accountants, IMA), studied the causal factors that can lead to fraudulent financial reporting and were concerning to identify steps and provide recommendations to help reducing the incidence of fraudulent financial reporting. It organized the Committee of Sponsoring Organizations (COSO) in 1985 in order to develop internal control frameworks providing criteria for evaluation of internal control systems. The first document was released in 1992, Internal Control—Integrated Framework, known as COSO 1. It attributes the responsibility for internal control to the board of directors, directors and employees that should assure: (a) efficacy and efficiency on operations; (b) accountability on financial reports; and (c) compliance to legal and rules. This development fits so well to aspiration of regulators that AICPA substituted the internal control definition in SAS 55 by the COSO's ones when issued SAS 78. From then on, COSO 1 turned to be a reference to independent auditors in their evaluation of internal controls and in their opinion issuing. In 1996, COSO published another document, the Internal Control Issues in Derivatives Usage, as this type of financial instrumental was so new as complex [40].

The Information System Audit and Control Association—ISACA, a non-profit association of 140.000 professionals in 187 countries was established in 1969 with the purpose to set guidance in the growing field of auditing controls for computer systems. In 1994, it released the Control Objectives for Information and Related Technology (COBIT), a framework for the governance and management of firm's IT [41].

Regarding principles of corporate governance, important steps were taken around the world. The Committee on the Financial Aspects of Corporate Governance, established in 1991, set the first organized set of principles on United Kingdom. It was known as Cadbury Report and was published in 1992 as a response to increasing lack of investor confidence in the honesty and accountability of listed companies and low level confidence in ability of auditors to provide expected safeguards. The 1980s was considered a golden era of creative accounting also in UK. Some spectacular frauds and collapses between 1990 and 1991 outraged society and investors, as Bank of Credit and Commerce International (BCCI), The Mirror Group and Polly Peck. This led to the creation of the Cadbury Report that established a non-statutory Code of Best Practice on financial governance—the Combined Code [9, 42]. Among all recommendation, there are:

- The majority of Board members to be non-executive directors (fraud cases presented non-executive directors but they were not effective).
- The setting up of an audit committee with overall responsibility to review the financial statements and the accounting policies employed.
- The separation of chairman position from chief executive.
- To emphasize the responsibility of directors over the institution of internal control systems

London Stock Exchange required listed companies to *comply or explain* this code. This principle would become the cornerstone of UK corporate governance practice, and this was spread around the world.

Since then, other countries and even Europe as a community intensified the debate on governance issues. In 1996, the European Association of Securities Dealers (EASD) created the EASDAQ, an electronic stock market for fast growing internationally oriented companies and in 1997 set a Corporate Governance Committee [9]. In 1997, Frankfurt created the Neue Markt, specifically to high tech new business but required a more restrictive rules of corporate governance related to kind of stocks and transparency on quarterly financial reporting. They should be based on a more friendly accounting system as USGAAP (Generally Accepted Accounting Principles developed in the US) or IAS (International Accounting Standards) [43]. In 1998, worried about bank failures, excessive CEOs paying, ineffective role of auditors board and how to revive the Japanese economy, the Corporate Governance Forum of Japan proposed its Governance Principles reproducing some aspects of American governance corporate monitoring practices and prior European documents, as independence of boards [44].

Finally, in 1999, it was published a set of principles that became a reference worldwide. This seemed to be a convergence of prior efforts. It follows a brief history of this institution and the main principles and recommendations.

European members believed that a post-war way to ensure peace was to encourage co-operation. They created the Organization for European Economic Cooperation (OEEC) in 1948, and with Canada and the US, it was created the Organization for Economic Co-operation and Development (OECD) in 1961 with the purpose of promoting policies that would improve the economic and social well-being of people around the world. By providing forums, governments from diverse countries (39 in nowadays) can work together to share experiences and seek solutions to common problems [45]. The OECD Council meeting in 1998 called to develop a set of corporate governance standards and guidelines. The result of this effort among member countries and relevant organizations was the first edition of OECD Principles of Corporate Governance [1]. These principles have also been adopted as one of the Financial Stability Board's Key Standards for Sound Financial Systems and form the basis for the World Bank Reports on the Observance of Standards and Codes (ROSC) in the area of corporate governance. They stated:

"Good corporate governance helps, too, to ensure that corporations take into account the interests of a wide range of constituencies, as well as of the communities within which they operate, and that their boards are accountable to the company and the shareholders. This, in turn, helps to assure that corporations operate for the benefit of society as a whole. It helps to maintain the confidence of investors–both foreign and domestic–and to attract more patient, long-term capital". (p. 5)

Different environment, traditions and legal systems can adapt these principles in different ways. The aim of this document was to set principles by them governments could evaluate and improve their laws and regulation, and private companies could design its own set of practices.

It seemed that good corporate governance practices would improve confidence on capital market and this was important to financial stability, which indirectly would benefit society. Notwithstanding, it is not clear that corporations will operate for the benefit of society as a whole. They believed that shareholders were interested on long-term performance and reputation and to achieve this it was important to consider societal interests [13]. It is an assumption that was echoed by many authors of corporate governance issues, but it is beyond the control possibilities emerged by these principles and good practices derived from them.

Environment, communities and societal interests are not reachable by corporate governance framework. The attendance to them is invisible to general public up to a scandal. As this constitutes a fundamental to the principles, companies disclosure many actions to show their environmental and societal responsibilities and this is bought as a true. What is disclosure often is a true (except in fraud cases) but there is no managerial tool that can check or evaluate what has not being done. Compliance in these issues is complex and dispersed in many regulatory norms and stakeholders interests. Some big companies in oil, gas and mining sector disclosure environmental responsibilities and attendance to international principles and index, but from time to time, there is a scandal of a spectacular environmental accident. It is not unusual that further analysis explicit that there was not an accident at all.

A huge accident in 1980s was the Exxon Valdez (1989) in Alaska and seemed that a crisis plan was not used, as it was too expensive [46]. A recent world largest accident occurred in Brazil, in late 2015, in Mariana town and affected many cities (over 40) down the River Doce, crossing two states up to the Atlantic Ocean (approx. 600 km). The partnership responsible for that was two giant companies with good reputation even in corporate governance: the Brazilian company Vale and the Australian BHP Billiton. Despite the expected revision on national mining code and regulatory efficacy, the point to be highlighted here is that this kind of negligence is very difficult to be accessed by boards or stakeholders communities as regulatory and auditing reports signalize compliance [47–49]. It is interesting to note that Vale had been preparing its Sustainability Report based on Global Reporting Initiative (GRI), a reference to transparency on risk and opportunities companies face [50].

Returning to the principles [1], they focused on problems resulted from separation of ownership and control and those questions about environment and societal concerns, although stated as an expectation, were treated more explicitly in other documents. Principles run about:

a. The right of shareholders. It relates to basic ones as shares registration and transfer, to receive timely and regular information about corporation, to participate and vote in shareholder meetings, mainly in decisions concerning statutes changes, share issues and sale of the company.

b. The equitable treatment of shareholders. Within the same class of shares, they should have the same voting rights and board members and managers should disclosure any material transactions that could affect corporation.

c. The role of stakeholders in corporate governance. Stakeholders right established by law should be protected and so be considered by corporate governance framework. They should receive relevant information when they participate on corporate governance.

d. Disclosure and transparency. Governance framework should assure timely and accurate disclosure of corporation information regarding financial situation, performance, ownership and governance. Information should be prepared in accordance with high quality of accounting standards and audited by independent auditor annually.

e. The responsibilities of the board. Board should review and guide corporate strategic and other important issues, monitor and take decisions on key executives performance and remuneration, assure the integrity of financial information systems including independent audit and assure an appropriate systems for monitoring risk, financial control and compliance with the law. Board is supposed to monitor and manage potential conflicts of interest of managers, board members and shareholders. All those recommendations about the structure of a board (independence, separation of chairman and chief executive roles) are contemplated by this document as annotations.

The main concerns emerged along these two decades were attended in some way by all these principles developed by several countries and by the OECD. They related to executives remuneration, the quality of accounting and financial information and independence of auditor and board members.

Notwithstanding, the capacity of misrepresentation was out of reach of all these enforcements, allowing companies to bypass them and intensify even more their malpractices. Along these two decades, society turned to be more spectacular characterized by rapid changes, mass communication and dissociation between substance and image [51, 52].

"In a age, when the average consumer has only the vaguest notion of the actual activities of a vast, complex corporation, the public image of the corporation substitutes for more specific or more circumstantial notions of what is actually going on". [52, p. 191]

In the image Era, celebrity is a short path to gain legitimacy from broader public and stakeholders. Celebrity promotes a positive emotional response leading to a favorable perception of a firm's quality and ability, even if its performance and historical data do not suggest this. Media play an important role as it controls the content to be divulgated and the instrument to do it. It dramatizes a story where companies are protagonists. These external narratives would help companies create an internal positive sense-making of what was going on and weak internal control did not represent a red flag [28, 53, 54].

In an environment that emphasizes a narcissistic culture, a message more than its content, with a media planting pseudo events, executives and companies also turned their attention to manage this impression about them. If reality was not so attractive and enforcements were being setting in order to restrict their behaviors, there was an intrinsic incentive to pseudo-actions and structures with placebo effects on people's impressions and definition of reality [51, 55–57]. Then, companies and their executives applied impression management on financial statements and communication [9, 21, 58, 59], on corporate governance [55] as on internal culture, control systems and negotiation [60, 61]. The *accounting for growth* and *accounting for profit* made history in this last decade [55, 62]. The spontaneous norm was: "Do whatever you can to show the profit rate is growing (…) whatever you can" [62, p. 231].

If in the 1980s, the misstatements were concentrated on earnings manipulation shenanigans [58, 63], in the 1990s with increasing concern regarding financial situation and excessive remuneration, two other groups of shenanigans were adopted: cash flow and key metric misrepresentation or fraud [9]. And it must be added to this list the external auditors role as helping companies in creative accounting and storytelling about numbers [64] and, ineffective audit committees [65].

Finally, the reduction in regulatory oversight as in severity and probability of being convicted for fraudulent accounting practices, added to lack of specialized knowledge of board members, analysts and regulators agents, complemented the enforcement landscape of the 1990s and the early 2000s [66, 67].

5. The 2000s crisis up to 2008: folly in financial services sector

Corporate scandals were the focus on the early 2000s, and enforcements were designed to restrict firm behavior.

A survey of CFOs (40 countries, between 2000 and 2001) showed that the lack of adequate disclosure of information (risk taking, company's strategy and plans and financial goals) was an issue of most concern around the world [68]. It illustrates that spectacular scandals were not isolated cases.

Among the most outrageous scandals at this time were Enron, Worldcom, Tyco and Parmalat. The first to break out was Enron, in late 2001. They fabricated revenues, misreported cash flows and intensively used SPEs and offshores to hide off balance sheet liabilities and to enhance volume of sale transactions, among many others scams. It is worthy to highlight that along 2000 year Enron still figured as one of the biggest company in the USA and ranked seventh on the Fortune 500 list [9, 21, 69].

Enron was an example of what had been practiced by many companies around the world. The problem was its size and power to broad contaminate the financial system. Its collapse showed up the limits of those malpractices that had been overlooked by regulatory agents, boards, auditing firms and other stakeholders. It was an emblematic case of corporate fraud [70]. Creative accounting can be used within the boundaries of regulation but fraud usually goes beyond, without being perceived or at least, stopped [9]. The image and globalized era turned this kind of fraud a threat to capitalism system.

Among varied practices used to perpetrate the fraud, Enron created a business non regulated, promised unreal gains, fragmented processes in order to control employees by rotinization and socialization and to diffuse culpabilities, granted exceptional compensation for deviant activities, created a complex structure of companies to simulate transactions, executed accounting frauds to cheat investors, auditing and regulation and got involvement of third parties (auditing, politicians, analysts, rating agencies and financial institutions) (see [29, 53, 68–72]). All of these were facilitated by the mega spectacle of image projecting accessing cognitively the ideology of power and competence, neutralizing any critical position. The power spectacle arouses obedience and the competence spectacle grant business legitimacy, even when this clashes with substantial evidences [70].

Principles of corporate governance consolidated in the late 1990s, highlighted the need of controlling the executive remuneration, the quality of accounting information and independence of board members. Corporate frauds usually bypassed these recommendation and created a sense making that excessive remuneration was result of smart guys competence (the Masters of Universe staff); since Enron was the second largest client of Arthur Andersen and the largest of rating agencies, it got their involvement overlooking the red flags on business; and finally, the chairman and chief executive officer was the same person but he was a celebrity [15, 72].

In summary, it was created a smokescreen that did not allow accessing the non-compliance and even rationalized it. What Enron scandal brought to light was that lenient behavior toward governance recommendations would not promote an excellent performance in New Economy but instead, would facilitate and legitimate corporation frauds and add a great risk to financial system.

In the summer of 2002, WorldCom collapsed. It operated for years releasing reserves into income created by creative accounting on acquisitions. Financially struggled, they inflated cash flow, capitalizing what should be expensed. Despite being a fraud much simpler than Enron, it was huge in amount of money. It was also client of Arthur Andersen [9, 15, 21]. That was the same mechanism used by Tyco, the other scandal of 2002. By creating reserves in acquisition operations, they inflated income and when an event struggled his cash, operating cash flow was also inflated. It was client of PwC [9].

Vivendi, Ahold and Parmalat inaugurated the scandals time in Europe [73–75]. They were cases of report of non-existent asset, non-report of liabilities, cash-flow misrepresentation and frauds, off-balance sheet assets and other creative accounting to inflate revenues. They were also client of important auditing firms like Arthur Andersen, Grant Thornton, Deloitte & Touche. Ineffective corporate governance figured in the list of failures.

This sequence of scandals did not affect the confidence only on capital market but also on auditors, supposed to confer accounting information and procedures. Therefore, it is time to run some considerations about auditing firms. They faced a great crisis of confidence, as they were part of the problems that culminated into scandals. To Arthur Andersen, however, the punishment was drastic. It seemed that they went out of business not in function of audit failures since many other times they faced lawsuits of this kind, but they deliberated destroyed documents obstructing justice and characterizing a widespread criminal conduct. The verdict, however, was not based on destruction itself but on an email sent to Enron warning that earnings announcements for SEC in October should be altered in order to give them less information [15]. These conducts would be considered in further regulation.

The auditing activity was born in Great Britain with industrial revolution. Join stock companies supplied increased demand of huge sum of capital. The British Companies Act of 1845, with the purpose of protecting investor from incompetence or malfeasance of directors, required that companies must keep detailed accounting records and be annually audited by a committee of shareholders [15].

The accounting industry started to be competitive in late 1970s and in 1980s audit fees felt down drastically. From them on, this industry saw a concentration phenomenon into a Big 5 auditing firms that started also to offer consulting services to aggregate value. Besides the revenue concentration, they started to concentrate power as well, and they were protagonist on many lobbies to avoid regulation, as that of SFAS 23 in 1996 and then the auditor's independence requirement pos-2000 scandal [15, 29]. Increasing consulting services turned this proximity to managers to be promiscuous. This last regulation required the separation of consulting and auditing services and was a SEC's effort to avoid problems of noncompliance. It was motivated by a scandal involving PwC in January 2000, when it came to public that more than its 1.500 auditors were accused of violating professional standards. But it suffered an intense opposition by auditing firms. Forty-six members of Congress asked SEC to withdraw, amend or delay the proposal. After lobbying that could result in a retaliatory cut on SEC's budget, it allowed companies to continue to offer other services conditioning the separately disclosure of them in November 2000. When firms disclosed revenues from tax and consulting services in 2001, even SEC was astonished [15]. An Audit Committee to oversee the audit process became a necessity more than a desirable characteristic of corporate governance (e.g. [29]).

Academic studies continued to be conducted over companies from 1990s to the first years of 2000s. The results were not so different from prior ones. There were some inconsistencies

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depending on analytical method or sample but most of them highlighted the preferences to outside directors not overcommitted (when they serve on many boards, they have less time to do a good job), to separation of chairman from CEO roles, to audit committees that meet more frequently and have more financial expert members (e.g. [36, 76, 77]). All of these were considered in further regulation and codes.

The environmental conditions that surrounded these scandals yet included impression management. Besides companies that effectively had weak corporate governance, some others adopted board independence, for instance, just to demonstrate governance compliance to financial stakeholders, without actual improvements on it. It is part of verbal impression management by CEO in communications to analysts [55].

After Enron collapse news broke in November 2001, followed by revelations about Arthur Andersen and other companies involved, improvements on governance could not be postponed anymore.

More than 30 Bills were drafted along the first semester of 2002. Two of them were approved. The first was the Republican Oxley's Bill approved in April 2002 by the House of Congress. It created the special Board to regulate auditor activities and restricted consulting services provided by them. But it was softer than expected by part of Democrats. The second one, the Sarbanes's Bill, was running on Senate but in slow motion. Approved on a special Commission in June 2002, it seemed that it would not be scheduled for final approval as senators were mobilizing around the election of November. What changed the course of this history was the break out of WorldCom scandal. American society was not recovered from Enrons's scandal to face another one with that proportion. The Sarbanes's Bill was approved in July 15 by a vote of 97 to 0 [15].

Then the Act that promoted a great reform became known as Sarbanes-Oxley Act of 2002. The purpose was once again to restore investor confidence on financial market. Among many objectives, there were the enhancement of corporate responsibility and financial disclosure as so the avoidance of corporate and accounting fraud. It was a temptation to broad responsibilities and applies more severe punishments to companies and their executives [2, 9, 15, 61].

In order to operationalize this enforcement, SOX created the Public Company Accounting Oversight Board—PCAOB, to oversee the activities of the auditing profession. PCAOB was under SEC direction and was funding by auditing firms and clients. The banning of consulting activities was not required but it was explicitly prohibited nine specific services deemed incompatible with auditing: bookkeeping, financial information system design and implementation, actuarial services, internal audit outsourcing, investment banking services, legal advice, appraisal services and executive recruiting [15]. The main responsibilities of the Board contemplate registering public accounting firms and conducting periodic inspections to ensure that they comply with expected standards. They can investigate and impose sanctions to audit failures. It is not a surprise that once again a strong congressional lobby took place to prevent the indication of a president for PCAOB that would execute SOX's requirements effectively.

SOX, along its eleven chapters [3]:

- Required that audit firms rotate the lead engagement partner every 5 years.
- Prohibited auditing services to firms where CEO, CFO, CAO or controller was previously employed at the accounting firms and has participated in the audit of that company in previous years.
- Emphasized the auditor's responsibilities to board of directors, investing public and managers.
- Required Audit Committee members to be independent and responsible for appointing, compensation and overseeing the company's independent auditors. They should receive and investigate complaints about accounting and auditing matters. One of their members should be financial expertise and all should be also members of Board of Directors.
- Required corporate executives to certify in writing that financial statements comply with standards, free of misrepresentation. If there was a problem with that, this certification would allow them to be subject to civil and criminal penalties (20 years in prison). Those internal controls that were fragmented to dilute and diffuse culpabilities now lose efficacy.
- Prohibited loans to officers and directors.
- Limited benefits plans to employees.
- Required more disclosure of off-balance sheet financing.
- Increased the maximum prison sentences for securities fraud executed by mail and wire (20 years) and for documents destruction during a federal investigation or bankruptcy (20 years).

SOX required that SEC regularly revised companies disclosures and statements considering some red flags: if they restated financial information many times, if stock price suffered a huge volatility in comparison to other companies, emerging companies with disparate proportion between profit and prices and companies that significantly affect economy. These aspects of its revision all addressed to signals presented on corporate fraud companies showing that things were not going that good but were overlooked.

SEC had proposed management reporting on internal control effectiveness a couple of times before, as in 1979 and 1988, but only with SOX, there was a final rule about it. The SOX's section 404 relates to it. It requires that an internal control report be produced annually. This report attests the responsibility of directors in structuring and keeping an internal control system proper to accountability.

Although Section 404 did not mention COSO, it was then the main available instrumental to execute its requirements. COSO revised and reissued the Internal Control Guidance and continued to improve it until the recent version of 2013, yet addressing to Section 404 of SOX. Context of 20 years back did not include internet, email, outsourcing activities, and the role of boards and audit committee was pretty different, which required some updated. All of these changes had affected internal control management. This revision also emphasized principles and its attributes (not so explicit in 1992 version) and broadened the objectives. SOX focused on financial reporting but framework focused also on compliance and operation as well [40, 78].

The COSO is a framework organized in Cubes. The COSO 2013 combines three categories of objectives: operations, reporting and compliance. These objectives are reached with good internal controls in five integrated components: environment, risk assessment, activities, information and communication and monitoring activities. All these controls are spread into different levels of company structure: entity as a whole, divisional, operating unit and functional level. Although SOX does not require IT audit in this frame, COBIT was seen as a complementary framework to COSO internal control. COBIT focuses on IT processes and their relationship with internal control, based on COSO definition [40, 41].

SOX still requires that be provided information about risk taken by company and mainly material weaknesses. There are many forms to manage risks but the framework issued by COSO, The Enterprise Risk Management (ERM)—Integrated Framework, known as COSO 2, also became popular worldwide. The distinction of the frameworks developed by them was that it started with objectives and not with risks. There are risks in achieving those objectives and controls to mitigate them. It is important to company explicit that some strategies require risks to be taken and other risks are taken by choice.

Since SOX, other requirements about risk oversight processes were issued. Audit Committees were required to oversee these processes by New York Stock Exchange in 2004 and SEC required broad information about board's role in risk oversight in 2009 [79]. This movement turned more intense after 2008 crunch, to be commented in the next section.

One of the main issues highlighted in 1990s, which figured as part of problem in some corporate scandals of early 2000s, was the stock option not expensed—a risk neither measured nor disclosure. Despite feverous academic discussion about that (e.g. [25, 80]), FASB proposed the SFAS 123R in December 2004, requiring that employee stock options be valued on the date they were awarded and expensed the vesting period of them. It was an intermediary solution. This discussion leads to the controversy regarding the adoption of IFRS in USA.

After 2000 scandals, an increased number of countries started to adopt the International Financial Reporting Standards (IFRS) set by International Accounting Standard Board (IASB). Now, there are 149 jurisdictions that had already converted to it. Its mission is to bring transparency, accountability and efficiency to financial markets around the world, contributing to financial stability. The specific IFRS no 2—Accounting for Share-Based Payments started to be discussed on 2000 and was issued in 2004 [81]. Differences between IFRS 2 and SFAS 123R would impact earnings report, effective tax rate and cash flow [82]. A bigger challenge lies on the fundamental difference between European and American standards. While American rules privilege *form over essence* and are more rules-based model, Europeans privilege *essence over form* and are more principle-based model. There are other economic implications to U.S. companies and political ones to FASB, which does not want to lose its supremacy [83, 84].

An important signal that companies were misrepresenting and enforcements were putting increased pressure on them was the restatements level. In 1997, 116 listed companies in the USA restated their financial reports, between 1997 and 1989 there were 292, but the number increased to 330 companies only in 2002. After SOX, in 2004 and 2005, there were 1.818 earning restatements [15, 62]. A study conducted over 919 restatements between 1997 and 2002 found that the most of them were driven by deceptive accounting practices [85]. Approximately 10% of all listed companies restated their financial information at least once during this period of time [15].

Corporate accounting scandals led to important reactions that created laws, rules and code of conducts. Over the time, all these regulations become cumulative and environment more complex. Increased penalties, punishments, stricter regulations seemed not to avoid creative accounting and malpractices [67, 86, 87]. Instead of being effective against misconducting, all these effort turn environment yet more complex and vulnerable [9].

Notwithstanding, it is worthy to point out that SOX did not reverse the deregulation of financial market. There was an amendment to SOX approved in 2003—The Securities Fraud Deterrence and Investor Restitution Act that actually limited states activities to uncover frauds. Therefore, mutual fund was protected from over regulation. FASB and SEC continued to be politically influenced by lobbies [29].

6. The 2008s crisis: a different one

The credit crunch of 2008 was surrounded by a market overleveraged, debt misrated by rating agencies and incorrect investment banking models [88]. The result was that financial institutions, investors, analysts and rating agencies underestimated the level of toxicity of assets held in portfolios–consciously or not [9]. Complexity, lawful creative accounting and greed, all elements presented in prior frauds and scandals, contributed to it.

Trading models were usually constructed by traders that do not know how to interpret data within them. Some of them had never read the financial statements of companies used to model, but financial sector rely on them [88]. Although the reputation of rating agencies had been affected by 2000s scandals as they kept their high rating level up to the scandal time or too near (and it does not matter here if there was corruption involved on it), financial market used them to give credibility to portfolios. And once again, they sustained ratings even when scandals were eminent, like in Bear Stearns case [9, 88].

Financial market was too leveraged with credit derivatives, based on bad lending practices. When the leverage is high, the quality of loans should also be high to reduce risk. Mortgage loans conceded to people that could not afford the payments, known as sub-prime, were packaged up creating the securitization instrumentals as collateralized debt obligation (CDO) that could be backed by many combination of debt: credit derivatives, asset-backed securities, mortgage-backed securities and the most famous as credit default swaps (CDS) and collateralized mortgage obligation (CMO) [9, 88].

What intensified the effect of contamination of this crisis on entire financial market was the fact that losers were not only the investors that deliberated bet on financial game but people aware of it around the world. The participation of hedge funds in this crisis deserves a comment.

Hedge funds are for rich investors and as rich they enacted an image of sophisticated investors. Many public pension funds and other institutional investors allocated their money in hedge funds. In 1990, there were a few hundred hedge funds managing up to US$ 50 billion assets. In 2008, there were around 8.000 global hedge funds managing almost US$ 3 trillion in assets–all of these under little regulation [88]. The illusionism and the spectacle used in Enron's world were intensified within this financial folly. The excuse for secrecy was used by hedge funds. It was not so different from Enron's discourse about measurement of its derivatives. What is new and not regulated open a window to flourish this modus operandi [70].

The greed was also fed by spectacular possibilities of getting rich fast, increasing the anxiety to goes beyond. The whistle blowing and articles in media questioning the performance of hedge funds were misled [89]. It is important here to recover the team phenomenon described by Goffman [57] years ago. He stated that people create a mutual confidence on each other within the team leading to a reciprocal dependence where the objective is to sustain the representation, the impression to determined audience. The reciprocity is reinforced with the purpose of self-protection, reaffirming the consensus. Open disagreement with consensus is not socially accepted. That what's happened in 2008.

If this impression management was efficient to general public and useful to specialized one that chose to participate in the folly, it should not be overlooked and ignored by SEC. Derivatives instrument had also been used by Enron to spectacular fraud. SOX promoted a huge change in corporate governance and accounting activities but did not reach this market functioning [87]. As SEC did not halt securitization activity, investment banks accelerated it in 2007. It seemed that there was a conflict of interest as some SEC's officials used to work for investment banks, for law firms that represented them, became affiliated with a private equity fund or even started one financed by investment banks [88].

Rating agencies were part of this spectacle. Seen as providers of comprehension concerning complex asset-backed securities tranches, they misrated them, which were used by financial institutions to justify investment and leverage. In March 2007, Bloomberg asserted that 90 percent of bonds in the AAA index of S&P were not even investment grade, in other words, would be rated above BBB- (see [88]).

When the world's second largest private equity firm collapsed, on March 2008, their assets were mostly AAA rated and they affected many important creditors. The American response was an exchange of these AAA papers for treasuries, issuing a US$ 200 billion lending program to provide liquidity to the U.S. banking system. This unprecedented action included U.S. taxpayers in losers list.

Accounting rules allowed some classification that could favor financial firms to hide the effective risk embodied in its assets. Then SEC, after this billionaire program, encouraged companies to classify assets using models with significant unobservable inputs. If FASB rules allowed companies to do it under some circumstances, SEC was announcing that that was the circumstance [88]. Accounting errors and some investigation were in course in 2006, but they were not red flag enough to halt the folly.

This collapse was spread around the world as bank system is interlinked, turning to be a global credit crisis. Nationalization and public rescue programs were replicated in Europe in order to protect financial system (see [9]). Financial stability depended on taxpayers and probably the extension of social impacts of increasing public debt was not been measured yet.

Carlyle Group, Bearn Sterns, Lehman Brothers, AIG, Merril Lynch, Wells Fargo and many others, were directly involved on this crisis. The Madoff case, however, was pretty different. It was a corporate fraud like others of 1990s that survived longer as its distinction was that there was no transaction at all, no business. SEC received six complaints against Madoff between 1992 and 1998 [90, 91], which raised many red flags [92]. Notwithstanding, Madoff Ponzi scheme was only broke out when investors started to demand their money back as they were losing with credit crunch in other investments. Only in 2008 investors took of US$ 12 billion from Madoff's fund, and this led to the collapse of it. The Madoff case turned explicit how feeder funds activities were so unregulated [9, 93].

One of the important responses was The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 [94]. This Act finally imposed some regulation back over financial market. Among recommendations, Federal Reserve should supervise any company that gets too big to fail. The consequence was the increase of its reserve requirement. President Trump has announced that this increased reserve drained financial resources from banks and decreased their competitiveness.

The Volcker rule prohibited banks from using hedge funds in its behalf and determines 7 years to bank get out of hedge fund business. Banks lobbies were successful in delaying this approval (only in 2013), and new pressures can decrease enforcement by regulators.

The Act required that risky derivatives like CDS be regulated and all hedge funds and other advisors as well. All of them must be registered with the SEC. It created an Office of Credit Ratings at the SEC in order to oversee rating agencies, with the power to require methodologies and deregister them.

It created the Consumer Financial Protection Bureau under U.S. Treasury Department to assure that homeowners be aware of risky mortgage loans, to oversees and regulates credit activity, and also require banks to verify borrower's income, credit history and job status. Banks and funds in 2008 crisis overlooked all of this information. As it depends on public budget, it is easy to relax the enforcements on it. Under the same U.S. Treasury Department the Act created a Federal Insurance Office in order to increase supervision of insurance companies, mainly over those that create a risk for entire system, like AIG.

Finally, the Act gave power to the Government Accountability Office to audit Fed's emergency loans like that in financial crisis and required that The Treasury Department approve any other emergency loan given by the FED. This was a response to protect taxpayers from new financial folly.

7. Corporate Governance after 2008 global crisis

After the great shock, corporate governance is still considered important by shareholders and investors particularly during times of financial trouble [4, 95].

The OECD report on financial crisis in 2010 pointed out the weaknesses in corporate governance that contributed to financial crisis. They run about the lack of risk assessment and disclosure, high-risk exposure, lack of financial experience among board members and remuneration still linked to short term gains [96].

It reinforces the responsibility of boards on executive remuneration definition, on the establishment of an explicit governance process that defines the role and duties of compensation consultants and on making this process transparent. It is important to note that those consultants were not so independent as expected and were too closed to managers since 1990s.

It states that risk management should consider compensation and incentive systems, and its process and assessment about its effectiveness should be disclosure. This theme is a direct result of credit crisis.

It recommends that internal control functions report directly to audit committee and risk management directly to the board. SOX and SEC required some improvements on internal control, but this recommendation addresses the responsibilities over processes.

Board structure, composition and working practices have being related to good governance and avoidance of frauds. This report considers that these characteristics can vary depending on complexity of business and so they need to be adequate to it.

For those companies that are subject to supervision, this report recommends that this include issues regarding to skills and competence of board members related to general governance and risk management. Assessment of independence and objectivity of board members could include the length of time members serve under the same CEO. The lack of competence and financial skills was pointed as an important factor in 2000–2008 crises as board members overlooked some important red flags and did not do the right questions about business (e.g. [21]).

Finally, it recommends the need to improve the exercise of shareholder rights, especially institutional shareholders that figured as important victims in financial crisis.

Sharing this diagnose, UK and US regulators took some steps to encourage banks to improve its culture by governance and added regulatory enhancements to financial supervisory regime in name of global financial stability. Although the UK and the US are too different, they converged on ideas to increase penalties to failures and to change focus from interest of shareholders over all other stakeholders to interest of clients [97].

The OECD non-biding principles of Corporate Governance were revised in 2004 after 2000 scandals and in 2010 after credit crunch. From 1999 version, it was included an item to help companies to enhance the effectiveness of corporate governance framework.

In 2004, this item stated: "The corporate governance framework should **promote transparent and efficient markets**, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities" [p. 17]. It follows with some recommendations to do it. In the 2010 version it states: "The corporate governance framework should **promote transparent and fair markets, and the efficient allocation of resources**. (…)" [p. 13]. All elements of 2004 were repeated here to help jurisdiction in articulating legal, institutional and regulatory framework that affect corporate governance. The subtle substitution of *efficient market* to *fair market and efficient allocation of resources* addresses to concerns on focusing only shareholders over other stakeholders before 2008 crisis. The new concern should be on global financial stability. Specifically, it added a sub item related to stock market regulation that should set standards, supervision and required enforcement of corporate governance rules. Other sub-item was added related to the importance of international co-operation among regulators in providing arrangements for exchange of information. The 2010 version also explicit the *comply or explain* principle as a recommendation to jurisdictions in its implementation arrangements. This enhances enforcements.

Other detachments were made in function of its importance change. The sub-item related to institutional investors was detached in 2010 and states that they should disclosure their corporate governance policies and consider other forms of shareholder engagement. Another detachment relates to information about board members, including their qualifications, the selection process, other company directorships and whether they are regarded as independent by the board. This sub item was within remuneration theme in 2004.

In synthesis, the main items of OECD 2010 are: (a) ensuring the basis for an effective corporate governance framework; (b) the rights and equitable treatment of shareholders and key ownership functions; (c) institutional investors, stock markets, and other intermediaries; (d) the role of stakeholders in corporate governance; (e) disclosure and transparency; and (f) the responsibilities of the board.

Legal and regulatory apparatus and corporate governance codes around the world were adjusted to the main aspects related to frauds and scandals in financial crises. As cultural, economic and legal arrangements are different among countries, the degree of enforcement can also be different. The last financial crisis showed that restrictions would be bypassed if there is a huge economic interest in game.

Corporate governance is important to govern in shaping its legal and regulatory frameworks, incorporating governance requirements. It is important to drive shareholders and stakeholders in arising the right questions about business. If they have skills to do it, if they want to do it or are sensitive to impression management that cloud their mind, this is out of reach of all these frameworks.

A global survey on governance conducted by McKinsey in 2011, unfortunately did not present a better result than the previous one in 2008. Boards have not increased time spending to discuss company's strategy, and 44% simply review and approve companies proposed strategies [98]. The main findings were that some directors have inadequate expertise about business and have no time to more dedication. Delloite's report on risk management added to this discussion the market volatility that has been driven ERM in companies pos-crisis [99].

If these surveys reflect reality abroad, we still have a big problem to face. Probably managers and boards are not applying what was learned from prior crisis in required speedy and intensity.

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Chapter 3

Corporate Governance Codes and Their Role in Improving Corporate Governance Practice

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Additional information is available at the end of the chapter

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Abstract

Good corporate governance (CG) is primarily the responsibility of every company, and both hard law and soft law should provide comprehensive corporate governance framework, thereby encouraging the introduction of high governance standards and best practices in the companies' corporate governance system. The aim of this contribution is to broaden understanding on the role of codes of good governance in improving corporate governance practice on the case of Slovenia. The findings of research studies and analyses of the content of the Slovenian CG Code and its adoption in Slovenian companies show that the code has been playing an important role in developing corporate governance practice in Slovenia. Additionally, such analyses provide important cognitions on the adoption of the CG Code in Slovenian companies by revealing improvements in the governance practice and indicating those areas where changes are required. That is a way such monitoring and analyses should be done on the regular basis together with reporting on the monitoring results. This can considerably contribute to better understanding of the code's recommendations among companies, promote debate and thus foster awareness of the underlying issues. Future analyses should address not only the statements on compliance but also how companies actually implement the code's recommendations.

Keywords: corporate governance, corporate governance code, disclosure, transition economy, Slovenia

1. Introduction

Numerous research studies in the corporate governance (CG) field are based on a universal model outlined by principal-agent theory where central premise is that shareholders and managers have different objectives and different access to firm-specific information.

Self-interested managers as agents of shareholders (principals) have the opportunity to take actions that benefit themselves, and shareholders are those that bear the costs of such actions (i.e. agency costs) [1, 2]. In many countries, not only managers but also controlling shareholders can expropriate minority shareholders and creditors [3, 4]. Several mechanisms are proposed to resolve principal-agent problems such as monitoring by boards of directors or large outside shareholders, equity-based managerial incentives or the market for corporate control [1, 2, 5]. These different types of control and monitoring in companies are referred to as corporate governance [2, 6].

Many cases of corporate fraud, accounting scandals and other organizational failures leading to lawsuits, resignations or even bankruptcy have made corporate governance as especially important and often discussed topic among professionals and scholars. The main feature of many of these cases is the assumption that the system of checks and balances designed to prevent potentially self-interested managers from engaging in activities detrimental to the welfare of shareholders and stakeholders failed [2]. Several formal regulations and informal guidelines, recommendations, codes and standards of corporate governance have been established or improved in order to determine good corporate governance. These efforts to improve corporate governance practices have raised an important dilemma within the corporate governance field, whether to develop hard law (i.e. mandatory requirements, hard regulations and regulatory approach) or soft law (i.e. voluntary recommendations, soft regulations and market-based approach) in order to improve corporate governance across countries [7, 8]. In this contribution, we explore governance codes that are a form of soft regulations (i.e. soft law) presenting a set of voluntary best governance practices without the force of law [7, 9, 10]. The issue of the Cadbury Report and the Code of Best Practices in the UK importantly affects the diffusion of codes around the world after 1992 [7], and similar effects on new codes' creation or revision of the existing ones can be observed after 2008 due to the global financial crisis [10].

The number of research studies on codes of good governance has considerably expanded after 1992 and especially in the early 2000s [7, 10]. Because of the voluntary nature of the majority of codes, there has been a considerable debate in the literature on whether the code recommendations affect the corporate governance quality [7, 8]. Research studies demonstrate that the introduction of corporate governance standards in the form of a code has positive effects on the evolution of governance practices [10] and especially on transparency and disclosure [8, 11].

The aim of this contribution is to broaden our understanding on the role of corporate governance codes in improving corporate governance practice. We explore how the introduction of corporate governance code influences the corporate governance quality in the case of Slovenia. We selected the case of Slovenia due to the lack of research that would address codes' evolution and their adoption in the transition economies [12]. Slovenia is one of the transition countries that present a large sub-category of emerging economies [13]. As a new European state, it was founded in 1991, and has been in last decades under several transition processes [12, 14, 15]. Even though some authors [16] claim that Slovenia is no more a transition countries since it joined the European Union (EU), several indicators show that economic transition from routine to innovative economy and society has not been finished yet in this country [17, 18]. In the case of Slovenia, we limit our research on the corporate governance codes, which were created at the national level as the result of joint efforts of the Ljubljana Stock Exchange (LJSE), the Managers' Association of Slovenia and the Slovenian Directors' Association. We did not explore any other codes and their adoption in the governance practice of Slovenian companies that are relatively free in selecting their governance code.

The paper is divided into several sections. Following the introduction section, the literature review on corporate governance codes is conducted followed by the study of the case of Slovenia. In order to provide a comprehensive insight into the introduction of corporate governance codes in Slovenia and their impact on the quality of corporate governance practice in Slovenian companies, we explored the corporate governance framework in Slovenia and conducted comparable analysis of data on the codes adoption in Slovenian companies. Concluding section highlights the most important findings, implications for research and practice, and future research directions.

2. Theoretical background

2.1. Institutional environments and corporate governance systems

A universal model outlined by principal-agent theory dominates the corporate governance research field. Its central premise is that shareholders and managers have different interests and objectives as well as different access to specific information of a company. That is a way self-interested managers have the opportunity to take actions that benefit themselves, and shareholders are those that bear the costs of these actions. Such costs are referred to as agency costs [1, 2]. In many countries, it has been noted that not only managers but also controlling shareholders (both are also referred as insiders) can expropriate minority shareholders and creditors (referred also as outsiders) [3, 4].

Several scholars [1, 5] criticize the closed-system approach within agency theory that implies a universal and direct linkage between corporate governance practices and performance and devotes little attention to the distinct contexts in which companies function. They claim that the structure of governance systems is influenced by several external forces such as efficiency of local capital markets, legal tradition, and reliability of accounting standards, regulatory enforcement, and societal and cultural values [2, 19, 20]. Research studies show that there are substantial variations in institutional environments that shape the degree and nature of agency conflicts and the effectiveness of corporate governance mechanisms [21, 22].

Schiehll et al. [22, p. 180] suggest that corporate governance system should be viewed as 'bundles of interrelated or even intertwined external (country-level) and internal (firm-level) forces, which provide structures and processes of the relationship between firm's management and stakeholders'. They also apply the term national governance bundles, which are 'configurations of governance mechanisms that simultaneously operate at the firm and national levels to govern firms within an overall economy or collection of economies' (p. 180).

The historical path dependence among country- and firm-level mechanisms results in a variety of country- and organization-specific governance systems that are effective within the institutional environments in which they have been developed [23].

Therefore, we believe that understanding of attempts in distinguishing and describing different institutional environments and corporate governance systems enables us to more appropriately asses the role of corporate governance codes in improving corporate governance practices.

When distinguishing corporate governance systems, two perspectives should be considered based on the role of companies in the society [2, 24]. Taking a shareholder perspective, where a company's primary obligation is to maximize shareholder value, effective corporate governance should protect shareholders from being expropriated by the management [2, 24]. The system of corporate governance in the Anglo-Saxon countries is characterized as a shareholder-based system [2, 24] and the law strongly protects shareholders [20]. Anglo-Saxon countries' firms are relatively widely held (low ownership concentration). It is estimated that in the USA and the UK, the largest five shareholders hold on average 20–25% of the outstanding shares. Due to this fact, on one hand less mechanisms shareholders can use effectively to influence managerial decision-making in a direct manner [24], but on the other hand 'interdependence among institutions may lead to substitution among functionally equivalent corporate governance mechanisms' [5, p. 980]. Examples include takeover markets in the USA and the UK, where external governance in the form of the market for corporate control with the takeover threat presents disciplining mechanisms for managers [5].

In most European and Asian countries, the stakeholder-based systems prevail [2, 24]. From stakeholder perspective, where a company has a societal obligation that goes beyond increasing shareholder value, effective governance should 'support policies that produce stable and safe employment, provide acceptable standard of living for workers, mitigate risk for debt holders, and improve the community and environment' [2, p. 9]. In the majority of these countries, ownership concentration is significantly higher than in Anglo-Saxon countries [25]. For example, in Germany the largest five shareholders hold on average 41% of the outstanding shares [24]. Concentrated ownership on one hand may reduce agency costs stemming from the separation of ownership and control, but on the other hand may induce new conflicts that arise between majority and minority shareholders. The primary agency problem in this institutional context is the possible expropriation of minority shareholders by the controlling shareholders such as related-party transactions [5]. Therefore, in countries where a vast majority of companies has a concentrated ownership and control structure, the function of corporate governance regulation is to minimize the extent of agency problems between majority and minority shareholders and that between shareholders and creditors [24]. As noted by Larcker and Tayan [2, p. 9] 'the governance system that maximizes shareholder value might not be the same as the one that maximizes stakeholder value'.

In relation to the previously discussed perspectives, scholars often made division of corporate governance systems between the Anglo-American and the Continental European system. While short-term equity finance, dispersed ownership, stronger shareholder rights, active market for capital control and flexible labour market characterize the first one, the Continental

European corporate governance system is characterized by long-term debt financing, concentrated block-holder ownership, weak shareholder rights, inactive markets for capital control and rigid labour markets [19].

Combination of the Continental European capitalism characterized by large controlling shareholders and elements of entrepreneurial or founders capitalism mostly associated with the USA is characteristic of new emerging capitalism not only in the transitions economies of Central and Eastern Europe but also in other parts of the world [26]. Many transition economies (i.e. former socialist countries) are characterized by a relatively high level of ownership concentration leading to the agency problems between majority and minority shareholders. Concentration of ownership in the hands of a few or even one block-holder assures a significant control and direct influence on the nomination and control of management team, which for this reason cannot be expected to be independent [26, 27].

A legal system and tradition also has important implications for corporate governance system [2]. According to institutional theory, legal rules and norms are important component of national institutional systems [5]. In terms of legal origins, common-law and non-common-law (i.e. civil-law) countries are distinguished [2], even though this corporate governance research stream has been criticized due to its simplistic theoretical and empirical grounds [5]. Non-common-law countries (such as Germany, Scandinavia and French countries) are countries with poorer investor protection, and have smaller and narrower capital (both equity and debt) markets and less widely held companies (more ownership concentration) than common-law countries (such as UK). Countries whose legal system is based on a tradition of common law afford more rights to shareholders and more protection to creditors than countries whose legal systems are based on civil law (or code law) [28].

In common-law countries, there are mainly information asymmetry and agency problems between managers and (majority) shareholders; in non-common-law countries, these are mainly information asymmetry and agency problems between minority and majority shareholders. The research findings of Bauwhede and Willekens [29] showed that the level of corporate governance disclosure was significantly lower in non-common-law countries than in common-law countries due to the greater pressure that shareholders can put on managers in comparison to the pressure minority shareholders can put on majority shareholders.

2.2. Corporate governance codes

2.2.1. Codes as a form of soft governance regulations

Several authors [7, 8] identified as an important dilemma within the corporate governance field on whether to develop *hard law* (i.e. mandatory requirements, hard regulations and regulatory approach) or *soft law* (i.e. voluntary recommendations, soft regulations and market-based approach) in order to improve corporate governance across countries. Hard laws are legal requirements regarding governance mechanisms in a country issued by a government in order to improve governance practice and prevent conflict of interests [2, 30]. According to the opinion of several researchers, one of the most important pieces of formal legislation is the Sarbanes-Oxley Act of 2002 (Sox) issued in the USA as a reaction on several cases of failure along many legal and ethical dimensions [2, 7, 30]. Regarding corporate governance legislation, Larcker and Tayan [2] identify an important issue on how such legislation is prepared—whether it has its origins in rigorous corporate governance theory and empirical research or it is more the product of political adequacy. Berglöf and Pajuste [26, p. 182] also address this issue by claiming that large controlling owners 'tend to get involved in politics influencing the legislative and regulatory processes as well as the enforcement of adopted laws and regulation'.

Corporate governance codes are a form of soft regulations or the so-called soft law. They comprise a set of voluntary best governance practices and do not have the force of law [7, 9, 10]. Governance codes are established to 'address deficiencies in the corporate governance system by recommending a comprehensive set of norms on the role and composition of the board of directors, relationships with shareholders and top management, auditing and information disclosure, and the selection, remuneration, and dismissal of directors and top managers' [31, pp. 417–418]. Cromme [30, p. 364] claims that the governance codes' key function is transparency as 'there can be no better form of control than transparency, for open explanation of management decisions is a major plus point for company credibility'. High-quality disclosure on companies' corporate governance arrangements and increased transparency to the market provides information to investors, facilitates their investment decisions and brings 'reputational benefits for companies, and more legitimacy in the eyes of stakeholders and society as a whole' [32, Article 4]. Research studies show that the introduction of a code positively influences the evolution of companies' governance practices [10]. Even though there are several reasons behind companies' decision to comply with the codes' recommendations, especially two reasons are in front, and that are to increase companies' legitimation among investors and to improve the effectiveness of companies' governance practices.

Corporate governance codes 'do encourage companies to implement stronger corporate governance structures and release more information in a timelier manner to market participants' [8, p. 475]. According to Nowland [8, p. 477], the success of codes 'relies on market mechanisms enticing or pressuring companies to improve their governance and disclosure practices'.

Corporate governance codes can be developed *at the national level, the level of an individual company and at the international level* [10]. Individually or jointly, governments, stock exchanges, employer associations and director associations can issue governance codes in order to address corporate governance specifics in a particular country and to improve the national corporate governance system, especially in the case when other governance mechanisms fail to do that [31]. In authors' opinion, the issuer's ability to enforce changes in governance of companies importantly affects the codes' role in improving governance practice. Governance codes that are issued by governments and stock exchanges have stronger enforceability since they present a norm of operation and therefore might have a stronger impact on improving governance practice. Codes that are developed by professional associations, directors or management associations have lower enforceability due to their voluntary nature and therefore have lower impact on the promotion of good governance practice.

When a firm introduces its own code, the main objective of such a code is 'to establish, and to communicate to investors and other stakeholders, the governance principles adopted by the firm' [10, p. 223]. In this case, a code applies only to that company. Transnational institutions such as the World Bank, the Organization for Economic Cooperation and Development (OECD) and the International Corporate Governance Network (ICGN) have also created governance codes. The introduction of such codes highlights their importance for prosperity of national economies and specific geographic regions. They are usually more general than a governance code established at the national or firm level [7, 10]. The issue of this type of codes started at the end of the 1990s (first such code was issued in 1996), and there were 14 transnational institutions that issued 21 corporate governance codes by the end of 2014 [10]. A majority of codes issued by transnational institutions are developed for listed companies. However, an increasing number of codes have been issued for non-listed companies, for special types of companies (e.g. state-owned and family ones) or for different types of financial institutions [10, 33]. Governance codes issued by transnational organizations are important for two reasons according to Aguilera and Cuervo-Cazurra [7]. Firstly, they emphasize the importance of good corporate governance and provide best governance practices across several countries. Secondly, they can provide basis for the creation of national governance codes. There is evidence that the creation of national governance codes usually accelerates after the issue of influential transnational codes and the occurrence of corporate scandals and frauds [10].

National governance codes 'tend to be adapted to the country's economic environment and address the country's most salient governance problems' [31, p. 436]. The so-called domestic forces influencing the development of governance codes refer to demands from investors who prefer better protection of their interests. Codes are then introduced to improve governance practice and to close the perceived gap in the domestic national governance system and improve its efficiency. That is often in the cases when other governance mechanisms (e.g. takeover markets and legal environment) fail to protect adequately shareholders' rights [31]. In some countries, corporate collapses and scandals triggered the issues or revisions of corporate governance codes. For example, in Cyprus, the Cyprus Stock Exchanges introduced the Cypriot Corporate Governance Code in 2002 as a response to the major stock exchange collapse [34].

2.2.2. The role of codes in convergence of governance practices

Some evidence [7, 30, 35] demonstrate that governance codes can be viewed as mechanisms facilitating governance convergence across countries. Such convergence is the result of several external forces among which the most powerful are globalization, market liberalization and influential foreign investors [7, 30]. Namely, globalization, the internalization of markets and deregulation have led to rapid changes in traditionally grounded models of corporate governance [19]. These external forces 'lead to pressure on national governments, institutions and companies, to conform to internationally accepted best practices of corporate governance at the international level' [12, p. 54], thereby influencing the attractiveness of countries and companies for foreign investors. Countries that are more exposed to other national economic systems experience greater pressure to change governance practice not only to improve efficiency of domestic companies but also 'to harmonize the national corporate governance system with international best practices' [9, p. 4].

Several research findings on corporate governance codes revealed the governance convergence towards the Anglo-Saxon model (i.e. shareholder model) [30, 34, 35]. Governance codes, which are more in line with the Anglo-Saxon model, can be found not only in the established European economies [30] but also in emerging economies [34]. The explanation for this convergence may lay in the efforts of transnational organizations (e.g. the World Bank and the OECD) to promote those global standards of corporate governance that are more in line with Anglo-Saxon model [7]. The European Commission (EC) also encourages the convergence of governance practice in European countries by issuing recommendations in the area of corporate governance [7, 30, 32]. According to Cromme [30], the governance guidelines at the European level are highly aligned with the country codes. This can be due to the fact that certain governance issues (e.g. stakeholders rights and responsibilities) have been taken more seriously in countries of Continental Europe since 'their former weak capital markets are strengthened and institutional investors become more assertive in promoting more effective governance measures such as higher accountability and better disclosure' [7, p. 381]. Berglöf and Pajuste [26] claim that the introduction and the contents of governance codes of the Eastern European countries were the result of external pressure in terms of the EC corporate governance recommendations. The codes in these countries were largely determined by the demands that resulted from the EU accession process; many contents of the codes were also more or less copied from the UK and the USA codes. However, based on the research results on the comparison of the codes contents of the Eastern European countries, which are the EU member states, Hermes et al. [12] claim that domestic forces (e.g. the extent of enterprise restructuring, large-scale privatization and stock market development) in some of the analysed countries played an important role in shaping the codes' content.

Several scholars [1, 2, 20, 25, 36] raised doubt about 'one size fits all' corporate governance regulations. It is highly unlikely that a single set of best practices exist for all companies since corporate governance is a very complex and dynamic system and not all mechanisms may work well in all governance contexts [2]. The corporate governance practices and regulations should reflect particularities of companies' ownership and control structures that differ across countries and industries and determine the type and severity of agency costs [36].

2.3. 'Comply or explain' approach

The codes' voluntary nature is realized by the 'comply or explain' approach [7, 10] that is 'an enforcement mechanism that allows companies to deviate from the code norms, but at the same time requires them to disclose these deviations' [37, p. 255]. The basic idea of this approach is that a company has to disclose the compliance with recommendations of a particular code adopted by a company, or in the case of non-compliance, a company must explain the reasons for it [8]. The 'comply or explain' approach enables a company to adapt its governance practices to its particular circumstances [36], its size and shareholding structure [32, Article 7], to consider sectoral specifics [37], thereby allowing flexibility in choosing 'which corporate governance structure to adopt to better pursue their objectives' [10, p. 223]. Departing from the codes recommendations enables companies to govern themselves more effectively by adapting their corporate governance practice to their particularities [32, Article 7].

Differences exist among countries regarding the implementation of this approach. There are two ways of implementing the 'comply or explain' approach and that are mandatory and voluntary one [10]. The mandatory disclosure on the adaptation of code's recommendation or explanation of deviations is required by listing authorities (e.g. in Australia, Canada, Estonia, Luxemburg, Malta, Malaysia, Russia, Singapore and the UK) or by law (e.g. in several EU countries). The voluntary disclosure is present in some emerging economies (e.g. Algeria, Lebanon, Tunisia and Yemen). However, such lack of disclosure may decrease the effectiveness of governance codes since investors cannot understand 'if the company does not adapt the best practices or adopts the best practices, but does not disclose their adoption' [10, p. 224]. In the recent World Bank analysis [33] of corporate governance codes, 112 codes were found. Of the 112 codes, some 27 were purely voluntary with no link to regulatory frameworks, eight were mandatory and seven countries appeared to have some level of mandatory provisions. All other codes were variations of the 'comply or explain' approach.

The 'comply or explain' mandatory disclosure requirement is implemented by most stock exchanges. Companies listed on the stock exchange must explain the reasons for non-compliance with the (country) governance code in their annual report [30, 31, 36]. By realizing mandatory 'comply or explain' approach, the code 'helps companies exercise greater self-responsibility in their dealings with the capital market' [30, p. 364] and 'promotes culture of accountability, encouraging companies to reflect more on corporate governance arrangements' [32, Article 7]. Luo and Salterio [36, p. 460] claim that the disciplining power of this approach 'is the required public disclosure of governance practices that allows market participants to evaluate the effectiveness of the firm's governance system and to make informed assessments of whether noncompliance is justified in particular circumstances'. Appropriate disclosure of non-compliance with the code recommendations and of the reasons for these is very important for ensuring that stakeholders can make informed decisions about companies and for reducing information asymmetry between companies' management and shareholders, thus decreasing the monitoring costs [32, Article 17].

Several research findings demonstrate that listed companies tend to comply with codes recommendations [25, 36] which might be due 'to the market forces and pressures to comply with legitimating practices or "doing the right thing"' [31, p. 419]. Since the best governance practices are generally recognized as value enhancing, listed companies try to make clear explanation on why they do not comply with particular codes' recommendations [25]. Empirical evidences revealed some other factors that influence the rate of compliance with the codes' recommendations—see Ref. [10]. One of them is the firm size—larger companies require more sophisticated governance practices, their ownership structure is more dispersed and they are more under the control from the external environment (i.e. their greater visibility) [37]. Important factors are also the overall institutional environment, especially the legal norms and cultural values, and the development of national economy—the level of compliance with codes' recommendations is higher in developed than in developing countries that lack a tradition of sound corporate governance—see Ref. [10].

Even though analysis indicate gradual improvement in the way companies in the EU member states apply corporate governance codes, shortcomings were identified in the application of the 'comply or explain' approach. There are critiques of this approach as being ineffective due to 'the poor quality of explanations and because it provides a rather soft option, which proved in the financial crisis that it could not be trusted' [33, p. 70]. There are also interesting observations and empirical evidences regarding the explanations for deviations from codes' recommendations. In some European countries (e.g. UK, Netherlands and Germany), companies often use standard explanations for deviations, and often firms complying with the same recommendations use similar explanations for non-compliance. As the level of compliance increases over time, the quality of explanations for non-compliance remains very low showing only marginal improvements—see Ref. [10].

2.4. The diffusion of codes of good governance around the world

The first code came into being in the late 1970s in the USA. That was a period of 'transition from the conglomerate merger movement of the 1960s … to the empire-building behaviour by management through hostile takeovers … and to the shareholder rights movement of the late 1980s and early 1990s' [31, p. 418]. The year 1992 presents an important landmark in the development of governance codes around the world. That year, the Cadbury Report and the Code of Best Practices were issued in the UK, and since then the number of countries issuing governance codes has been increasing [7]. The Cadbury Report was a result of several financial scandals in the UK in the 1980s and early 1990s. This was the first corporate governance code adopted by the London Stock Exchange. The Cadbury Report is recognized in the literature and in the governance practice as one of the most influential codes, and several dimensions of that code were introduced into corporate governance systems not only in the UK but also around the world, including the USA and Germany [11]. After the issue of the Cadbury Report, the diffusion of codes has been rather slow and accelerated after the issue of both the OECD Principles of Corporate Governance and the ICGN Statement on Global Corporate Governance Principles in 1999. There were only nine countries that issued a code by 1997, while a further 34 countries issued their first code by 2002 [10].

Another important landmark in the diffusion of codes around the world presents the recent financial crisis (with beginnings in 2007–2008) and accompanying scandals that brought attention to the importance of introducing adequate governance mechanisms. The number of corporate governance codes has increased especially between 2009 and 2010 [10]. The recent analysis revealed that since the financial crisis codes have been and are being revised more often than before crisis. For example, the website of the European Corporate Governance Institute (ECGI) reported on 14 code revisions since 1 January 2015 [33].

The research findings show that first countries that issue governance codes, that is, the USA as first, followed by Hong Kong, Ireland, the UK and Canada, were countries with a common law, or English-based, legal system [7]. This is a more flexible legal system in contrast to civil-law system since judicial precedent shapes the interpretation of laws and their application. In the civil-law system, judiciary must base its decisions on strict interpretation of the laws that are issued by legislative bodies [2, 28]. Three types of the civil-law system exist and that are French, Scandinavian and Germanic. Research findings of Aguilera and Cuervo-Cazurra [31] indicate that codes are more likely to be issued in countries with a common-law system. In authors' opinion, there are two explanations for their research findings. Firstly, common-law countries, where strong shareholder rights are embedded in their legal system, are more likely to emphasize continuously good governance practice introduced by codes. Secondly, the common-law legal system's characteristics facilitate the enforceability of the codes. Even though in the common-law countries the good governance practice 'tend to reach the level of enforceability in courts, in civil-law system such practices do not have enforceability through the courts unless they become codified into law' [31, p. 434]. This cognition is confirmed by the research results of Zattoni and Cuomo [9] which show that countries with civil-law system issue codes later than common-law countries, and create fewer codes that often comprise ambiguous recommendations. Their research results suggest that 'the issuance of codes in civil-law countries is prompted more by legitimation reasons than by determination to dramatically improve the governance practices of national companies' [9, p. 12].

Aguilera and Cuervo-Cazurra [31] identified three exogenous pressures on the development of codes. The first pressure can be explained by the economic integration of a country in the world economy that positively influences the adoption of governance codes. The second pressure that is positively related to the code's adoption is the processes of government liberalization in a particular country. The withdrawal of government presence in the economy creates a need to establish new governance system in the newly privatized companies. The third pressure refers to the presence of foreign institutional investors that positively influence the code's adoption. Institutional investors search for companies with good governance practice since they need assurance for their investment to be protected.

Important research findings on codes' diffusion refer to the relationship between the development of capital markets and the number of governance codes. Countries with larger and deeper capital markets have more governance codes since 'the need for good governance increases as the number of public firms grows because agency problems between disperse owners and managers, or between majority and minority shareholders emerge' [7, p. 379]. Research findings show that developed countries issued more codes than developing countries that are more reluctant to revise their first code. Recent data show that 91 countries issued 345 codes by the end of 2014, of which 91 were first codes and 254 codes were revisions of previous codes. Developed European countries issued more than half of codes issued by all countries (174 out of 345), thereby playing a significant role in the diffusion of codes [10].

A majority of national codes are designed for listed companies. Recently, an increasing number of codes have been issued for specific types of companies (e.g. state-owned or family-owned), for different types of financial institutions (e.g. commercial banks, institutional investors and mutual funds) and for voluntary and charitable organizations [10].

The total number of codes issued in European countries increased after the publication of two important reports and that are The European Union Action Plan on 'Modernizing Company Law and Enhancing Corporate Governance in the EU' published in 2003 and the report by the High-Level Group on Financial Supervision in the EU published in 2009. The aims of both reports were encouraging the convergence of company law and corporate governance practices within the EU [10].

In the EU countries, governance codes are recognized to have a significant role in establishing principles of good corporate governance. Especially listed companies are required to include a corporate governance statement (CG Statement in their management report. In this statement, a company should disclose its corporate governance arrangement [Article 4(1) (14) of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004]. Since the 'comply or explain' approach is the key principle in the EU governance system, a company is required to explain in its corporate governance statement the deviations from the code's recommendations and the reasons for doing so [32, Article 4, 6]. A company is required to describe the alternative measure taken 'to ensure that the company action remains consistent with the objectives of the recommendation, and of the code' [32, Article 17]. In this respect, the EC emphasizes the required high quality of explanations on non-compliance reported by companies [32, Article 8, 11]. The EC recommendation on the quality of corporate governance reporting predominantly addresses listed companies. However, it suggests that other companies might also benefit by following the EC recommendation [32, Article 14].

In Germany, a corporate governance code was found as being unnecessary until 2002 when the German Corporate Governance Code (GCGC) was adopted [30]. This code contains standards of good governance that represent internationally and nationally recognized best practice. German companies are not required to follow these standards with the exception of listed companies. Listed companies have to disclose the (non)-compliance with the GCGC recommendations [37]. The research study by Talaulicar and Werder [37] showed high degrees of compliance with the GCGC, especially among German-listed companies. The authors were also able to identify some recommendations (i.e. 24 recommendations) that many companies do not comply with. However, in authors' opinion low rates of acceptance of these recommendations do not necessary imply that they need to be changed. On the contrary, such a situation may reflect 'that firms take advantage of the flexibility the code grants and disregard certain code norms in order to address company-specific peculiarities' [37, p. 268].

Hermes et al. [12] conducted a research on codes adoption in seven Eastern European countries or the so-called transition economies (i.e. Czech Republic, Hungary, Lithuania, Poland, Romania, Slovak Republic and Slovenia) that were at the time of the research already the EU member states. Romania was one of the first countries that issued a code in 2000. Other countries such as Slovenia and Hungary followed a few years later and issued a code in 2004. Twelve Eastern European countries issued their own code by the early 2006: Czech Republic (2001, 2004), Poland (2002, 2004), Russia (2002), Slovak Republic (2002), Macedonia, Ukraine (2003), Lithuania (2004), Slovenia (2004, 2005), Hungary (2004), Latvia (2005) and Estonia (2006); some of these countries published the new version of the code in the following years [12]. Hermes et al. [12] conducted analysis of the contents of the governance codes that are based on the analysed seven transition countries on the 'comply or explain' principle. They focused their research on three areas and that were disclosure rules, strengthening shareholder rights and modernizing boards.

Since in many cases these codes were adopted as listing requirement for stock exchanges, this gave codes a formal and compulsory character. The research results show that the codes of the Eastern European countries on average cover only around half of the EC recommendations. For some of the countries included in the research (especially Romania, Hungary and Poland), domestic forces related to country-specific characteristics of corporate governance system influenced considerably the contents of corporate governance codes. Codes in other countries covered a majority or almost all the EC recommendations of the governance principles [12].

Several research findings show that the adoption of corporate governance codes considerably affects the level of disclosures. Sheridan et al. [11] found this in the case of the UK where the introduction of governance standards in terms of reports concerning best practice and codes of good corporate was accompanied by a significant increase in the number of news announcements. The research in eight East Asian (i.e. Hong Kong, Indonesia, Malaysia, the Philippines, Singapore, South Korea, Taiwan and Thailand) countries indicates that voluntary national codes had both direct and indirect effects on companies' disclosure improvements. That is especially the case in those countries where codes have special sections designated to disclosure [8].

3. Corporate governance codes in Slovenia

3.1. Development of corporate governance codes

Slovenia is a new European state that was founded in 1991 and is nowadays one of the EU member states. Since the early 1990s, Slovenia like other Eastern European countries has made considerable efforts in transition to market economy [12, 26]. After its foundation, Slovenia has been faced with a three-way transition process [14]: (1) the transition to an independent state, (2) the reorientation from the former Yugoslav to Western-developed markets and (3) the transition to the market economy. These include several developments such as privatization of companies, trade liberalization, development of domestic financial markets and their integration to global capital markets, and development of the institutional framework in terms of regulations and law systems. All these developments have triggered the need to regulate the governance of companies in order to mitigate agency problems [12]. The transformation of companies' ownership from social into private one was realized based on the law on ownership transformation that came into force in 1992. The first Companies Act was adopted in 1993. Since then, corporate governance has been regulated by a number of acts that have been amended and supplemented as response to changes in legislation, market conditions and cases of good governance practice [15].

Corporate governance codes present an important element of corporate governance regulations in Slovenia. The first governance code was introduced for public joint stock companies. The Slovenian corporate governance code for public companies (in continuation: the Slovenian CG Code) was the result of joint efforts of the Ljubljana Stock Exchange, the Managers' Association of Slovenia and the Slovenian Directors' Association in creating recommendations on the best governance practices. The Slovenian CG Code came into force in 2004. Since then, the code has been revised several times: in 2005, 2007, 2009 and the last revised version of the code came into force in January 2017 [38–41]. Not only listed companies can apply the Slovenian CG Code's recommendations but also all those companies that would like to establish a transparent and understandable governance system [42].

First versions of the code included besides recommendations of the best governance practices also legal provisions on corporate governance. The Slovenian CG Code, which came into force in 2009, comprised only recommendations that are not legally binding (i.e. soft law). It is based on Slovenian legislation and incorporates 'the guidelines and recommendations of the European Union, principles of business ethics, internal bylaws of the three institutions (authors comment: the Ljubljana Stock Exchange, the Managers' Association of Slovenia, and the Slovenian Directors' Association) and the internationally recommended standards of diligent and sound corporate governance' [42, p. 2].

Companies, which are listed on the Slovenian-regulated market, must disclose to which code they adhere, any deviations from the code and reasons for them in their corporate governance statement, thus realizing the 'comply or explain' principle [43]. Shareholders have a right to demand additional explanations from a management board regarding the content of the statement at the shareholders meeting [40, 46]. According to the LJSE Rules [44] and LJSE Guidelines [45], prime and standard market companies are requested to disclose (non)-compliance with the code in the Statement on Compliance with the code that is the part of the CG Statement. The CG Statement was introduced by the Slovenian Companies Act [46] in 2009 and must be published as a part of annual reports. It is recommended that listed companies published it separately on their website [45]. This is in line with Article 20(1) of Directive 2013/34/EU that requires listed companies to provide information of their corporate governance arrangements as well as how they applied the relevant corporate governance code recommendations. It is believed that such requests would improve transparency for shareholders, investors and other stakeholders [32]. From 2015, the CG Statement is obligatory not only for listed companies but also for those companies that are bound to auditing.

Companies in Slovenia are relatively free in choosing a governance code to which they adhere. However, it is expected that companies listed on the prime and standard market of the Ljubljana Stock Exchange will largely follow the Slovenian CG Code [42, 47]. Companies can also create their own code, which might be a reasonable approach in the cases of adopting more codes. The selection of a code can also be influenced by the expectations or preferences of the company's shareholders [40]. However, other codes are not the subject of this contribution.

Since several research studies discussed in the next section explored the adoption of the CG Code from 2009 as well as this code has been adopted in the practice of Slovenian companies longer than any other Slovenian code did, we explain in more detail the content of this code. The recommendations of the CG Code from 2009 [42] cover several broad areas of corporate governance and that are corporate governance framework, relations with shareholders, supervisory board, management board, independence and loyalty of members of supervisory board and management board, audit and system of internal controls, and transparency of operation.

Recommendations in the area of the corporate governance framework:

- the management board together with supervisory board creates and adopts a Corporate Governance Policy (CG Policy);
- with the CG Policy they lay down major corporate governance outlines that should be compliant with the long-term goals of a company [42].

Recommendations in the area of the relations with shareholders:

- a company should ensure such a corporate governance system that treats equally all shareholders as well as encourage a responsible enforcement of shareholder rights;
- shareholders should be informed about the convening and progress of general meetings in a timely and accurate manner;
- a company should provide shareholders with reliable data that enables them to make informed assessments of the items on the general meeting's agenda [42].

Recommendations in the area of the supervisory board:

- the composition of the supervisory board should ensure responsible supervision and decision-making that are in the best interest of a company (i.e. re-members of the board should have professional expertise, experiences and skills);
- the selection procedure of the board members should be transparent and well defined in advanced;
- the board monitors a company, evaluates the work of the management board and actively cooperates in creating CG Policy;
- members of the supervisory board sign a statement in which they disclose whether they meet the criteria of independence and the possession of relevant professional training and know-how required to act as the supervisory board member;
- the president of the board is elected by simple majority;
- members of the board should be adequately paid for their work;
- the supervisory board sets us special committees dealing with special issues;
- the supervisory board assesses its work and work of its committees once a year [42].

Recommendations in the area of the management board:

- a company is managed by the management board that should ensure long-term performance by defining values and strategies;
- the composition of the management board should ensure decision-making in the best interest of a company and functioning in compliance with high ethical standards considering the interests of diverse groups of stakeholders;
- a remuneration system should enable composing of the managements board that best suits the needs of a company and ensures the alignment of the board's and the company's long-term interests [42].

Recommendations in the area of the independence and loyalty of members of supervisory board and management board:

- members of both boards make independent decisions taking into consideration the goals of a company [42].

Recommendations in the area of the audit and system of internal controls:

- an auditor is appointed in order to ensure an independent and impartial audit of the company's financial statements;
- an efficient system of internal controls is set up that also ensures a quality-risk management; together with its auditing committee, a company ensures periodical and impartial professional surveillance of the system of internal controls [42].

Recommendations in the area of the transparency of operation:

- a corporate communication strategy should be defined as a part of the CG Policy dictating high-quality standards in preparing and publishing accounting, financial and non-financial information;
- informing both shareholders and public should be set up in a manner providing equal, timely and economical access to information related to all aspects of a company;
- the company's governance practice is presented in the CG Statement taking into consideration the Companies Act;
- the Statement is a part of the annual report published as an independent document on the company's website [42].

At the beginning of 2017, a new version of the CG Code was issued where the purpose remains the same. That is to provide corporate governance recommendations for joint stock companies that are listed on the Ljubljana Stock Exchange. Other companies may also follow the CG Code's recommendations, thereby establishing transparent governance system in order to increase companies' legitimation among different groups of stakeholders (i.e. domestic and international investors, employees, banks, public, etc.). There are three main reasons for renewal of the previous version of the CG Code [48]:

- The regulatory framework has changed in the last 7 years. Several changes in legislation, especially in the area of corporate governance, reporting and public disclosure on governance system of a company came into force.
- Several changes in international and domestic recommended governance practice also importantly influenced a decision to renew the CG Code from 2009. In 2015, the OECD adopted new principles of corporate governance. Consequently, several countries have issued new codes (e.g. Austria, Finland, Germany, Denmark, Sweden, UK, Romania and Baltic countries). At the same time, advanced recommended governance practice has been developed in Slovenia (e.g. corporate governance codes for non-public companies in 2016, recommendation for auditing committee in 2016, practical advices for quality explanations in Statement on Compliance in 2015, etc.). The EC recommendations on the quality reporting on governance issued in 2014, which propose the EU members to monitor the codes' compliances, also importantly influence the development of the new CG Code in Slovenia.
- The results of the latest analysis of disclosures of compliances with the Slovenian CG Code from 2009 for the 2011–2014 periods (which are in more detail discussed in the next section)

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were also one of the reasons for introducing changes in the corporate governance recommendations of the CG Code. The analysis revealed those recommendations that the majority of companies complied with and which recommendations were among those that companies reported on non-compliances. The analysis and the issuers of the CG Code tried to improve those recommendations that were recognized as being described not clear enough, and therefore their introduction in the company's governance practice caused unnecessary problems.

Therefore, several changes were introduced in the new CG Code. We present the major changes by organizing them according to the major areas of the Slovenian CG Code from 2017 [48, 49]:

- *Corporate governance framework*: additional recommendation regarding diversity of the boards' membership and representation of both sex (i.e. women and men) in the boards and committees. The recommendations on the CG Statement now include additional explanation on how to prepare this statement. Previous analyses (LJE Analysis 2012 and 2015 that are discussed in the next section) revealed that several companies still did not understand the 'comply or explain' principle. The new CG Code also introduces the recommendation on external monitoring of the CG Statements, thus following the EC recommendation on the quality of corporate governance from 2014.
- *Relations with shareholders*: recommendations on equal treatment of shareholders were supplemented. Previous analyses indicate that recommendations in this respect were not comprehensive and clearly stated in the previous version of the code.
- *Supervisory board*: recommendations on self-evaluation of the supervisory board were updated. Recommendations on the audit committee were updated as well taking into consideration the new provisions of EC directives and the Slovenian Companies Act. Recommendations on additional training of the supervisory board members were added. These changes should positively influence the work of the supervisory board.
- *Management board:* recommendations on planning a succession in the management board were updated. Additionally, the tasks of the management board regarding the management system are recommended; the system should be transparent in terms of jurisdiction, connected with the risk management system and should encourage ethical and responsible behaviour of key stakeholders in a company.
- *Independence and loyalty of members of supervisory board and management board*: the definition of the independence is updated in order to make a clearer distinction between independence and conflict of interests. Criteria for conflict of interests are updated and more clearly presented. The recommendation on independence of the supervisory board members in this new CG Code extends to all members of the board (in previous version, this recommendation refers to only half of the board's members).
- *Transparency of operation:* several changes were made in this important area of corporate governance by taking into consideration the changes in legislation and the rules of the Ljubljana Stock Exchange. These updated recommendations also enable better comparisons among companies and transparency for all stakeholders.

3.2. The role of codes in improving corporate governance practice in Slovenia

Even though research studies on the adoption of governance codes in the corporate governance practice in Slovenia are scarce, the existent research results provide an important insight into the development of governance practice in Slovenia and the role of the corporate governance codes in this process. In this section, we analyse the findings of the previous research studies on governance codes in Slovenia. The structured content analysis was done chronically, starting with the research that explored the earlier version of the CG Code from 2005 and continuing with the research studies on the CG Code from 2009. The research conducted by the Ljubljana Stock Exchange together with the Slovenian Director's Association in 2015 [50] provides the most comprehensive insight into dynamics of the corporate governance codes' adoption and implementation of 'comply or explain' principle in Slovenian companies. Other research studies gave only partial and often static view in the role of governance codes in the practice of Slovene companies. The main research findings are presented in **Table 1**.

The Slovenian CG Code that came into force in 2005 (i.e. the revised version of the first code) was included in the *comparative analysis of the codes contents of seven Eastern European countries* (i.e. Czech Republic, Hungary, Lithuania, Poland, Romania, Slovak Republic and Slovenia) that was conducted by Hermes et al. [12]. The research covered three areas of recommendations that were disclosure rules, strengthening shareholder rights and modernizing boards. The main findings of the research were explained in one of the previous sections. In this section, we focus on the research findings for Slovenia.

The comparison of the Slovenian CG Code with respect to the EU recommendations on enhancing corporate governance disclosure showed that the Slovenian CG Code included five out of nine analysed recommendations. Those recommendations that were not included in the code were those not addressed in the codes of the majority of other six analysed countries as well. Research findings showed that 'openness from shareholders in general and from institutional investors in particular, with respect to their holdings and policies as major owners of companies' [12, p. 65] were not recommended by the analysed codes. The results can be explained by the corporate governance systems in these countries where important features are controlling shareholders and block-holdings. According to Berglöf and Pajuste [26], companies with controlling shareholders are less prone to disclose information.

The comparison of the Slovenian CG Code with respect to the EU recommendations on strengthening shareholder's rights shows that the Slovenian CG Code included two out of three analysed recommendations. Those were the recommendation dealing with providing shareholders information for evaluation of a company's performance and operations (not included only in the Romanian code), and the recommendation on shareholder democracy (i.e. the one share-one vote democracy). The last recommendation was found only in Slovenia and Lithuania [12].

Regarding the EU recommendations on modernizing the boards of directors, the Slovenian CG Code included four out of six analysed recommendations. Recommendations not included in the code were the recommendation on disclosure of the remuneration policy (included in three analysed codes) and the recommendation on prior approval by the shareholder meeting of share and share option schemes in which directors participate (included in four analysed

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Authors/source	The scope/subject of analysis	Sample	Code under investigation	Main findings
Research conducted by Hermes et al. [12]	Comparison of the codes' contents with the EU recommendations on disclosure rules, strengthening shareholders rights, modernizing boards.	Seven Eastern European countries, also the EU member states: Czech Republic, Poland, Russia, Slovak Republic, Russia, Macedonia, Ukraine, Lithuania, Slovenia, Hungary, Latvia and Estonia.	Slovenian CG Code 2005	Main findings: • codes' content of some countries differ from the best governance practices, • domestic forces related to specifics of national corporate governance systems shape the codes' content. Findings with respect to Slovenian CG Code: • recommendations on disclosure rules (five out of seven), • recommendations on strengthening shareholder rights (two out of three), • recommendations on modernizing board of directors (four out of six).
Ljubljana Stock Exchange with the support of the Slovenian Director's Association [40]	Disclosures of (non)-compliance with the Slovenian CG Code 2009 for 2010 and 2011.	Ten companies listed on the prime market of the Ljubljana Stock Exchange.	Slovenian CG Code 2009	• Companies on average comply with 81% of recommendations. • All companies comply with 63 (56%) out of total 112 recommendations. • The comparison between 2010 and 2011 shows that the level of compliance with the CG Code (2009) has been improving. • The quality of explanation of deviations should be improved.

Authors/source	The scope/subject of analysis	Sample	Code under investigation	Main findings
Ljubljana Stock Exchange together with the Slovenian Director's Association [50]	Disclosures of (non)-compliance with the Slovenian CG Code 2009 for 2011–2014.	Companies listed on the Ljubljana Stock Exchange: 58 companies for 2011 and 2013, 57 companies for 2012, and 60 companies for 2014.	Slovenian CG Code 2009	• The number of companies adopting the Slovenian CG Code (2009) has increased from 63.8% in 2011 to 71.7% in 2014. • Companies on average comply with 89.8% of recommendations in 2011, 90.6% in 2012, 89.9% in 2013, and 89.8% in 2014. • Companies complied with 22 recommendations (out of 112) in all observed years. • The number of specific, high quality explanations of deviations has ireased—23.5% of such specific explanations in 2011 and 27.8% in 2014. • Half of the most frequent deviations were deviations from the principles on the transparency.
The SEECGAN Index [38, 39]	The adoption of codes in the listed companies in Slovenia was explored by the following questions as a part of the SEECGAN Index methodology: • Has the company developed and publicly disclosed its own Corporate Governance (CG) Code? • Has the company adopted some official CG Code (CG Code of the Chamber of Commerce, CG Code of the Stock Exchange or similar)? • Does the Company disclose the extent to which it is complying with its Corporate Governance Code (does it explain possible deviations from the Code)?	All prime and standard market that were listed on the Ljubljana Stock Exchange in June 2014; in total 22 companies.	Any corporate governance code.	• More than three-quarter of prime and standard market companies disclose a code. • Companies refer to one of the official codes. • 88.9% of prime and all standard market companies disclose the compliance with the code and explain the deviations from it.

Table 1. Scope (subject) of analysis and major findings of the research on corporate governance codes in Slovenia.

codes). The Slovenian CG Code was the only code of the analysed ones that included the recommendation on the recognition in the annual accounts of the costs of share and share option schemes of directors [12]. These findings indicate that the Slovenian CG Code from 2005 already included recommendations not only on disclosure of fixed and variable remuneration of individual directors but also on disclosure of more sensitive information on how option and share schemes are constructed and how much that costs a company. These results indicate that the Slovenian CG Code introduced at that time many of the best governance practices at least in listed joint stock companies in Slovenia.

In 2012, the Ljubljana Stock Exchange initiated the analysis of the companies' disclosures on the compliance with the Slovenian CG Code from 2009. The analysis was conducted with the support of the Slovenian Director's Association. Ten companies listed on the prime market of the Ljubljana Stock Exchange were included in the analysis since these companies were expected to adhere to high governance standards. Companies were obliged to disclose any deviation from the code's recommendation together with the explanations in their annual reports. The main goal of the analysis was to explore the level of credibility and quality of explanations of deviations in accordance with the 'comply or explain' principle in order to identify those factors that could improve the quality of information on corporate governance system for investors [40]. The analysis and its results directly addressed the agency problem since an active monitoring of the governance mechanisms could present an additional pressure on the companies' management to consider the interests and goals of a company and not their personal interests and goals. The disclosures on compliance for 2010 and 2011 published in the annual reports in 2011and 2012 were the subject of the analysis.

The major findings of the analysis were that both the level of compliances with the best corporate governance practices and the quality of explanations of deviations from the CG Code's recommendations have increased in the observed period [40].

The results of the analysis indicated that two companies in 2011 and one company in 2010 complied with all code's recommendations. The rest of the analysed companies disclosed on average a compliance with 81% of the code's recommendations. More than half of total 112 code's recommendations were identified as those that all analysed companies complied with. The comparisons for the observed 2-year period show that the level of compliance with the CG Code from 2009 has been improving [40]. Such results suggested that companies have been trying to consider the CG Code's recommendations as much as possible, thereby also raising the quality of their governance practice.

The analysed listed companies disclosed deviations especially from the following six recommendations of the Slovenian CG Code from 2009 [40]:

- definition of goals in the company's statute,
- use of information technology to inform and conduct sessions of a supervisory board in a safe way,
- self-evaluation of the supervisory board composition, functioning, conflict of interests, co-operation with the management board and its committees once per year,

- the principle regarding payments of the supervisory board members that are determined at the shareholder meeting,
- appointment of an audit committee and a remuneration committee and a nomination committee as soon as possible after the constitutive meeting of a supervisory board,
- disclosure of payments of the members of a management board and a supervisory board.

Effectiveness of the CG Code in practice depends also on the transparency of deviations that should be reliable and complete. The detailed analysis of explanations of deviations shows that only 27% in 2010 and 44% in 2011 were such that could be classified as specific, high-quality explanations on deviations describing besides deviations also alternative governance practice and reasons for its adoption by a company [40].

Even though the quality of explanations of deviations has increased in the observed period, the comparisons of the reported disclosures and the actual governance practices raised an important question of the quality, completeness and credibility of these disclosures. The research results revealed that companies did not disclose all deviations mainly for two reasons. Firstly, companies did not interpret a particular recommendation correctly, and secondly, companies did not find a particular recommendation as relevant [40].

The Ljubljana Stock Exchange together with the Slovenian Director's Association conducted *the next analysis in 2015* in order to be able to observe development in the adoption of the CG Code from 2009. The analysis covered disclosures of compliances with the code for the 2011–2014 periods. The sample consisted of companies listed on the Ljubljana Stock Exchange: 58 companies for 2011 and 2013, 57 companies for 2012, and 60 companies for 2014 [50]. This sample was therefore much larger than the one of the 2012 analyses since it included not only prime market companies but also other companies listed on the Ljubljana Stock Exchange. The comparisons of the results of both analyses are therefore only limited possible. The major sources of data were companies' annual reports and especially the CG Statement with the Statement on Compliance with the code being a compulsory part of the annual report.

The first step in the analysis was to explore the adoption of the Slovenian CG Code from 2009 in the analysed companies. The results show that the share of companies adopting the Slovenian CG Code from 2009 has increased from 63.8% in 2011 to 71.7% in 2014. The analysis reveals that even though the law enables companies to select any publicly accessed corporate governance codes, only one company decided on such solution. Reasons for not adopting the Slovenian CG Code are diverse and are mainly due to the fact that companies [50]

- neither disclosed the code in their annual report nor published the CG Statement,
- referred to legislative and other regulations, internal rules and/or their Corporate Governance Policy,
- developed their own governance practice without adopting any official code,
- companies' shares were not traded at the market,
- referred to invalid CG Code (e.g. from 2007), and so on.

Results of the analysis on the compliance with the Slovenian CG Code show that only few companies comply with all 112 recommendations. Those were three companies in 2011, two companies in 2012, three companies in 2013 and four companies in 2014. Companies complied on average with 89.8% of recommendations in 2011, 90.6% of recommendations in 2012, 89.9% of recommendations in 2013 and 89.8% of recommendations in 2014. Only 22 recommendations (19.6%) were found that all analysed companies complied with in the observed period [50]. The percentage is lower than in the 2012 analysis, but we should take into consideration that in 2012 analysis only primer market companies were explored that are expected to adhere to the majority of the code's recommendation.

As stated in the report of the analysis [50], the number of companies complying with all code's recommendations is still low. However, this does not necessarily indicate lower quality of companies' governance practice. The main purpose of the analysis of compliance with the code's recommendations is not to ensure compliance with all recommendations if that is not an optimal solution for a company. If deviations are explained and alternative solutions are presented, such non-compliance indicates that a company has developed an alternative practice that best suits its specifics. Therefore, in-depth analysis of explanations was conducted. The findings demonstrate that the share of specific, high-quality explanations of deviations that described both deviations and alternative solutions has increased. The share of such high-quality explanations was 23.5% in 2011 and 27.8% in 2014 [50]. Even though the results suggest that companies have becoming aware of the importance of good disclosure practices, the quality of disclosures on deviations still needs to be improved. Contrary to the 2012 analysis, this analysis did not include investigation on whether companies really disclosed all deviations.

The results of the analysis also provide a comprehensive insight into those recommendations that companies did not comply with. The list of the most frequently disclosed deviations is organized per main areas of the CG Code accompanied with the data on the share of companies that disclosed deviations from a particular recommendation [50]:

- *Corporate governance framework*: definition of goals in the company's statute (29.3% companies in 2011 and 35% companies in 2014), creation of a Corporate Governance Policy (25.9% companies in 2011 and 31.7% companies in 2014).

- *Relations with shareholders*: a company encourages shareholders to disclose the policy of managing their investment (19% companies in 2011 and 23.4% companies in 2014).

- *Supervisory board*: the supervisory board functions in accordance with the code (27.6% companies in 2011 and 30% companies in 2014), setting up specialized committees (27.6% companies in 2011 and 28.4% companies in 2014).

- *Transparency of operation*: a corporate communication strategy (20.7% companies in 2011 and 21.7% companies in 2014), rules about the limitations for trading with the company's shares (17.2% companies in 2011 and 25% companies in 2014), public announcements and reports in foreign language (31% companies in 2011 and 40% companies in 2014), disclosure of remuneration of each member of the management board and of the supervisory board (17.2% companies in 2011 and 21.7% companies in 2014).

A closer look at the results shows that the share of companies disclosing deviations from particular recommendations has increased in the observed period. Half of the statistically most frequent deviations were those from the recommendations on the transparency.

Another research on corporate governance codes in Slovenia was conducted as a part of research on measuring the corporate governance quality by applying *the SEECGAN Index of Corporate Governance* [38, 39]. The main goal of the SEECGAN Index of Corporate Governance (the SEECGAN Index) is to enable assessment of the quality of governance practice in individual companies as well as the situation regarding overall corporate governance practice in a national economy. Additionally, it makes possible to compare corporate governance practices in South Eastern European countries since the SEECGAN Index methodology pays attention to the particularities of these economies. Seven governance categories are assessed [51, 52]:

1. Structure and Governance of Boards,
2. Transparency and Disclosure of Information,
3. Shareholders' Rights,
4. Corporate Social Responsibility,
5. Audit and Internal Control,
6. Corporate Risk Management and
7. Compensation/Remuneration.

All companies of the prime and standard market, in total 22 companies, that were listed on the Ljubljana Stock Exchange in June 2014 were explored. The main source of data was annual reports for the year 2013. Additionally, reports and documents published on the companies' websites were analysed. Research results revealed that more than three-quarter of the prime and the standard market companies disclosed a code. The majority of companies referred to one of the official codes. All standard market companies and 88.9% of the prime market companies disclosed the compliance with the corporate governance code and explained the deviations from it. Even though the disclosure of compliance with the chosen code is obligatory for the prime and the standard market companies in Slovenia [45, 46], one of the prime market companies did not disclose compliance with the code [39].

4. Conclusions

Good corporate governance is primarily the responsibility of every company and regulations at the national level taking into consideration specifics of the national economy, and the latest developments of governance practices and regulations at the European or even global level should ensure that certain governance standards are respected. Therefore, it is important that both hard law and soft law (i.e. especially corporate governance codes) provide comprehensive corporate governance framework, thereby encouraging the introduction of high governance standards and best practices in the companies' corporate governance system. This is of key importance for performance, growth and long-term sustainability of companies.

The findings of research studies and analyses discussed in this contribution show that the Slovenian CG Code has been playing an important role in developing corporate governance practice in Slovenia. Especially this is true for Slovenian-listed companies supporting cognitions by Aguilera and Cuervo-Cazurra [31] about the issuer's ability to enforce changes in the companies' governance system. Codes that are developed by the stock markets have strongest enforceability, since they are designed as the norm of operation, and thus having a greater impact on the promotion of good governance. The CG Code itself as well as mandatory disclosure of compliance with the code's recommendations serves as a guideline to different groups of stakeholders by clearly describing the particularities of the Slovene business world. Disclosures in the CG Statement based on 'comply or explain' approach should be specific and of high quality so that shareholders, investors and other stakeholders get a transparent and a reliable picture of the company's governance system.

The LJSE analyses from 2012 and 2015 of disclosures of compliances with the Slovenian CG Code [40, 50] show that the number of specific, high-quality explanations of deviations describing besides deviations also alternative solutions has increased. Even though these results indicate that companies have become aware of the importance of good disclosure practices, their share is still relatively low and therefore improvements are needed in this respect. Such situation is not specific for Slovenia, but has been noticed in other European countries where companies often use standard explanations of deviations, see [10]. The 'comply or explain' approach is effective only when high-quality explanations of deviations are disclosed. That is a way we find of crucial importance to raise awareness of the companies' key stakeholders on the main features of the high-quality explanations. According to the EC Recommendations, the high-quality explanations of deviations mean [32, Article 18]

- avoiding the use of the standardized language,
- focusing on the specific company context explaining the departure from a recommendation and
- the explanations should be structured and presented in such a way that they can be easily understood and used.

EC recommends companies [32; Section III, paragraph 8, 33; Section III, paragraph 8] to clearly state which specific recommendations they do not comply with and for each deviation, they should

- explain in what manner the company has departed from a recommendation;
- describe the reasons for the departure;
- describe how the decision to depart from the recommendation was taken within the company;
- where the departure is limited in time, explain when the company envisages complying with a particular recommendation;
- where applicable, describe the measure taken instead of compliance and explain how that measure achieves the underlying objective of the specific recommendation or of the code as a whole, or clarify how it contributes to good corporate governance of the company.

The research findings show that the level of compliance with the codes' recommendations has been increasing in Slovenia. However, as stated in both reports [40, 50], we cannot make a firm conclusion on the actual level of compliance with the CG Code's recommendations. Companies may not disclose all deviations or may find them as unimportant in their attempt to disclose compliance with as many recommendations as possible. That is a way companies should be made aware of the main purpose of the corporate governance code and accompanying 'comply or explain' approach since 'departing from a provision in the code could in some cases allow a company to govern itself more effectively' [32, p. 44]. A non-compliance with the 'best practice' which is accompanying with an explanation of how the alternative approach achieves the goal of the non-adopted recommendation can present significant benefit when creating the governance system that best suits the company's specific circumstances, see [36]. Companies should be aware of the flexibility enabled by the 'comply or explain' approach, and develop a governance system that in the best possible way addresses the company's specifics. The practice of not disclosing all deviations could be a very dangerous one since it can raise doubt about the implementations of the rest recommendations for which a company disclose compliance, see [40].

Both analyses on disclosures of compliances with the CG Code [40, 50] provide important cognitions on the adoption of the CG Code in Slovenian companies. Findings of such analyses reveal improvements in the governance practice and indicate those areas where changes are required. That is a way such monitoring and analysis should be done on the regular basis. Since we can observe high concentrated ownership in Slovenia [50] and companies with controlling shareholders are found to be less prone to disclose information [26], a regular monitoring of disclosures is of great importance. The EC recommends that public or specialized bodies should regularly monitor corporate governance statements published by companies in order to make 'comply or explain' approach effective [32, Article 19]. Shareholders should also perform effective monitoring in order to encourage good-quality explanations [32, Article 20]. Shareholders should play an active role in improving the quality of explanations in Slovenia as well. A dialogue between shareholders, a management board and a supervisory board is of great importance in the process of creating a suitable governance system. External institutions as professionals in monitoring the quality of disclosures [40] cannot do this. However, such professionals can play an important role in the process of monitoring due to knowledge and expertise they possess.

Reporting on the monitoring results can considerably contribute to better understanding of the code's recommendations among companies, promote debate and thus foster awareness of the underlying issues, see [26]. Regular monitoring of the codes adoption can provide legislators, policy makers and stock exchanges with an important insight into the effectiveness and efficiency of the codes, thus providing basis for developing and updating the recommendations 'in order to address the potential failures of corporate governance mechanisms' [10, p. 222]. Such monitoring can be the opportunity for regulators to 'make the rules less ambiguous' [26, p. 196] as it is the case with the last revision of the Slovenian CG Code that considered the findings of analysis of disclosures of compliances with the Slovenian CG Code from 2009 for the 2011–2014 periods.

The research studies and analysis not only in Slovenia but also in other surroundings deal mainly with the disclosures of compliance with the codes' recommendation. However, we believe that future research should address not only the statements on (non)-compliances but also how companies implement and practice the code's recommendations. Effective governance is demonstrated by the implementation of the regulations and recommendation in the practice and 'whether a code really contributes to improving practices depends on the extent to which companies actually comply with the recommendations in the code and to what extent compliances leads to changes in corporate behaviour' [12, p. 63]. We believe that a more in-depth analysis of the declared and implemented governance arrangements and their consequences is needed. An important contribution in this direction can be the SEECGAN Index that enables to measure how the codes' recommendations and national regulations contribute to the quality of corporate governance practice. The SEECGAN Index enables the comparisons of governance practices among South Eastern European countries, thereby creating a platform for debate about the best governance practices considering the specifics on national economies in that part of Europe.

Future research should also address the relationship among the code's compliance and the company's performance in general as well as in Slovenia. None of the researches and analyses conducted in Slovenia have addressed this question yet. We find this issue to be of great importance especially since mixed results about the impact of the level of compliance with the code's recommendations on companies' performance can be found in the literature, see [10]. Some research studies even showed that financial performance could justify non-compliance [7]. Diverse and mixed results can be explained by cognitions of several authors that corporate governance is a complex construct influenced by many factors, see [37]. Both the research and the practice regulated by different forms of hard and soft laws should adequately address the complexity of corporate governance construct. We hope that findings presented in this paper contribute to better understanding on how the codes of good governance as a form of soft law address this complexity and where improvements are required.

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INTECH

Chapter 4

Strategic Decision Making and Its Importance in Small Corporations

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Additional information is available at the end of the chapter

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Abstract

The global economic crisis has sharply affected thousands of small corporations and declared bankruptcy. It is likely that in the form in which they are working now, they will not be able to survive the economic pressure of competitors. Effective policy-making can be an important key to success. Analysis of the process of strategic decision making in small corporations is extensive research gap that we try to fill with the contribution. We put emphasis on strategic decisions, models of the strategic decision-making factors affecting the profile of these processes and mechanisms that make use of small corporation managers in strategic decision making. The conclusions of the research are identified the most important aspects influencing and forming process of strategic decision making by managers of small corporations.

Keywords: small corporation, strategic decision making, rationality, experience, satisfaction, cognition, emotion, reasoning

1. Introduction

Decision making is one of the basic management activities. At the top level of businesses there are strategic decisions that unlike tactical and operational decision making is more complicated, more complex and the consequences of strategic decisions are long-term character.

Small corporations are an important part of the economy in developed countries. According to the National Agency for Development of Small and Medium Enterprises (SMEs) in OECD countries represent more than 95% of the total number of all enterprises, while their share in the creation of added value is around 50% and the share of employment is within the average of about 60–70%.

The economic crisis has strongly affected the economy in this area, and thousands of small corporations declared bankruptcy. Most of them are dependent on a limited number of customers or subscribers and sales further decline. It is likely that in the form in which they are working now, they will not be able to survive the economic pressure of competitors.

It was found that effective strategic decision making significantly increases performance, success, and survival of small and very small corporations. Insight into the process of strategic decision-making small corporations is therefore important professional experience and literature. It presents a topic that received insufficient attention in comparison with the process of strategic decision making in large enterprises.

The following reasons brought us to explore the strategic decision-making process in small corporations:

- Strategic decision making in small corporations is significantly complicated by limited sources given by their organizational structure which represents low number of employees, they have few or no permanent employees, they have limited capital assets and simple technologies and processes, they do not have the capacity to use economies of scale, and they suffer from how to gain financial sources and how to survive in competition of bigger businesses.
- They are economically important, and they represent a high share of all the businesses.
- They are labor-intensive, informal, simple, and flexible; they are highly motivated to be successful following their ownership, lack of bureaucracy, and continuity thanks to the possibility of succession.
- They remain unrepresented in professional literature of the strategic decision making, thus there is an opportunity for further research in this area.

Research on strategic decision making was and mostly is focused on large businesses. There, we found a big research gap in the way the small corporations make their strategic decisions considering their difficult source limitation. We focused on small enterprises and mainly on micro-enterprises.

The pilot survey was conducted in 2012 on a sample of 70 small businesses. Subsequently, in 2015–2016, we have carried out major research project VEGA no.: 1/0109/17—"Innovative approaches in the management of their impact on the competitiveness and success of business in conditions in the Globalizing Economy."

Our aim is to find answers to the following questions: Is the strategic decision making part of their management? Which areas are covered by the strategic decisions of micro- and small enterprises? What models of the strategic decision making are dominant in these companies? What affects the profile of this process? What are the mechanisms used by managers of small corporations who make strategic decisions?

2. Theoretical background

Strategic decision making deals with poorly structured decision-making problems for which there is no clear procedure on how to solve them, leading to the decision [1].

The strategic decision for the company is considered to be the choice of the overall strategic orientation of the company which is followed by the decomposition of strategic decisions and consequently the tactical nature [2]. Effective strategic decisions are the result of a gradual, step-by-step on-going analysis of information [3].

Strategic decisions are intended to provide a competitive advantage and try to change the overall scope and direction of the company [4]. They are important for organizational health and survival [5].

In most businesses, however, strategic decision making is not about making those decisions. This is the documentation of the options which have already been made and often random. Therefore, leading companies reviewed approach to policy-making, so that their decisions are better and faster [6]. Solving strategic problems affects a large number of factors both inside the company and its surroundings. Many of them cannot be accurately quantified, exist between the complex and varying bond, and are difficult to interpret the information necessary for decision [7]. Adoption and implementation of strategic decisions is fundamental not only for large but also for small and micro-corporations, because they increase their performance [8].

Many theoretical models and approaches as well as the studies conducted in strategic decision making are focused primarily on large enterprises. Among the strategic decision of large and small corporations, however, there are some differences that result from the specific small corporations.

In a large enterprise, strategic decision covers three groups of people. They are business owners focused on the board or supervisory board, top management, and strategic management department. Among them, there is some division of labor. The process of strategic decision making takes place mostly in teams, whose composition is heterogeneous in terms of education, gender, age, experience, and functional jurisdiction. Top teams work to bring many ideas, constructive criticism, and influence other managers and also prevent the action of various cognitive errors, deviations from rationality, and personality traits of managers. Therefore, it is a large-scale enterprise that is more difficult for the head of the senior team to dominate the process of strategic decision making.

In small corporations, a strategic decision is focused on one or two persons (owner-manager or silent partner) and therefore is heavily influenced by the personality of the decision maker, its characteristics, subjective attitudes, and motivation [8]. Manager, often the owner, must have a managerial role as decision making and interpersonal or information. Who does not delegate a wide range of activities necessary for strategic decision making. An entrepreneur solver disputes allocator of resources, negotiators, leaders, coordinators, representatives, observers in one person, and at the same time should think strategically and be visionary.

In small corporations, there is no formal model of strategic decision making. Decision making is less complicated, passes through a few levels of management, therefore, is more centralized, it does not require extensive formal procedures, bureaucratic records, or documentation. Equal implementation requires significant and complex processes associated with communication and coordination activities. Small corporations have a few people on the acquisition, processing, and interpretation of vast amounts of information that are often ambiguous and it is necessary to understand them.

Based on the specific features stated above of strategic decision making in small corporations, it is necessary to adapt the generally applicable models and approaches to strategic decision making to these conditions.

2.1. Model approaches to the strategic decision-making process

Model approaches to the strategic decision making are different in many ways. The widely used criterion is the degree of application of rationality and exactness on the one hand and the use of intuition and experience of managers on the other.

2.1.1. Model approach: rational approaches

The majority of managers are convinced that their decision is rational and thus pursue consistent choices, maximizing value within certain limits. On the assumption of rationality-based normative theory, objective rationality presupposes full awareness of decision makers. It requires that the decision maker is able to determine the preferences of the elections and they are consistent. It is necessary to examine all the options to solve the problem and have all the necessary information. These assumptions result in a variant providing maximum utility [9]. Economically rational entity systematically tries to seek the best possible solution to the problem, and so maximizes their profit [10].

2.1.2. Model approach: limited-rational approaches

Due to unrealistic assumptions, achieving the objective rationality recognizes the limited rationality [11]. Also problematic is the requirement of full awareness of decision makers on all variants and their consequences, as well as the weak link between the information and the final decision [12]. Therefore, the limited rationality is considering working with the information, according to the decision maker at the moment sufficient and true [13]. Part of bounded rationality is a social rationality, which introduces elements of ethics in decision making [1] and emphasizes the ethical aspects as satisfactory and satisfying for the decision. Rewarding it is also called formal rationality, which requires adaptation to standards group, which is the decision-maker representatives [1]. Limited-rational approach applies the principle of satisfaction when the manager does not seek to achieve maximum effect, but only satisfactory solution that is better than originally expected. The effort to create more options is small. Especially in micro-owners-managers do not always reflect its objectives explicitly, and they tend to rely more on personal interests than economic. Such behavior is characterized by “satisfactory to the objectives” that leads to disobligingness to initiate changes in his/her business [14].

2.1.3. Model approach: intuitive approaches

On one hand, the need for the use of rationality is emphasized by the authors and that is in the sense of acceptance of the decisions based on the exact methods, which consist of the choice between the alternatives that are specified beforehand and which effects are known and calculable. On the other hand, broad application of rationality in strategic decision making is questioned and rationalized by the specific features of strategic decision making and inapplicability

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of many methods especially in conditions of uncertainty and difficulty of the outside environment. Therefore, intuition and experience take place. Intuitive approaches are used with strategic decisions concerned with people [15], with the detection of environmental threats and searching for opportunities in new situations, when the best ideas are needed. Strategic intuition is as important as strategic analysis and strategic planning [16].

Another reason is the reality that currently there are no "facts" oriented managers, which creates the pressure for using for the occasion approaches and experience-based approaches, the so-called experience-based management [17]. Especially managers in micro-businesses have the tendency to combine casually acquired information, heuristics, and other mental shortcuts into intuitive decision-making methods.

Beside the mentioned model approaches—rational, restricted-rational, and intuitive—there are other approaches in business literature that try to combine or diffuse the approaches mentioned above or try to incorporate other factors into the models of strategic decision making. Hitt, Tyler allocated three conceptual models of strategic decision making [18]: rational-normative model—it prefers objective index figures in strategic decision making, which emerge from the analysis of inner and outer business environment. Another one is a strategic choice model, which emerges from a limited rationality during strategic decision making. This means that the key agents are the subjective influence and the personality of the manager. The last model is external control model, which emphasizes the influence of external environment on strategic decision making. It is definitely not an easy task to prefer only one of these models. Even the authors themselves suggest that the trend is headed toward the integration of the abovementioned models. Elbanna and Child [19] developed an integrated model of the rationality of strategic decision making, which consists of three views affecting rationality—nature of the environment, business, and decision making itself. Calabretta et al. [20] similarly accept rational and intuitive accession like paradoxical thinking, developing outcomes through paradoxical thinking, not like an alternative decision operation. Rahman and De Feis [21] allocated model approaches toward strategic decision making based on two dimensions, which are time pressure and complexity of the environment. By doing this, they define incremental model (combining individual minor decision-making processes) and a Garbage Can Model which is based on the absence of traditional decision-making process from a problem to a solution; mutual separation of problems and solutions; tendency of businesses to produce many solutions, which are rejected for the reason of lack of the problems and their consecutive search in the "garbage can"; decisions are the results of the stream of several independent events under raised time pressure and elevated complexity of the environment. According to the scientific studies, exactly these two model approaches are used for strategic decision making by small corporations and micro-businesses. Emotions and decision making for strategic change under time pressure are analyzed by Treffers and Klarner [22], who demonstrate their findings, which they discuss, that negative rather than positive emotions influence strategic decision making and that their influences vary across decision-making phases. Their study contributes to strategy practice and strategy process research by integrating emotions as embodied practices during the strategic decision-making process. Kaufmann et al. [23] discuss that the key is rational processing and intuitive modes play a complementary role. They recommend that managers will use multiple decision-making models.

3. Methodology

3.1. Sample and design of the analysis

The research focused on the strategic decision making of small corporations was carried out on a sample of 210 companies. The subjects have been chosen on the basis of meeting criteria of a small company with regard to the number of employees (from 0 to 49) as well as on the basis of their willingness to offer information about the company and themselves in personal interviews. Primary and secondary data were put together. Primary data have been gathered according to a structured questionnaire and supplemented by managers and company owners' talks. A structured questionnaire has been created from more types of questions for research needs. Except from closed questions with the possibility of one correct answer, it contained open questions to be able to look deeper at problems. By offering possibilities to respondents, we could influence them while they are filling out the questionnaire. We put the main emphasis on the following fields:

- Strategic fields with strategic decisions in small corporations
- Factors that are triggers of strategic decision-making processes in small corporations
- Extent of rationality and intuition at strategic decisions—searching for relevant information while strategic decisions are created, analysis of information, the meaning of quantitative technique, effectiveness of subject decision making in data processing, and using of analytic and intuitive decision processes
- The way of concluding and making decisions
- Emotional, cognitive, and social managers' tendencies.

Secondary data have been used to complete analysis by marketing materials, information bulletins, and Internet pages of individual companies.

Chart 1 illustrates the survey of inspected corporations that had taken part in a survey of classification for micro-corporations (the number of employees from 0 to 9 and small corporations, the number of employees from 10 to 49).[1] **Chart 1** shows that 83% of enterprises from the studied sample are micro-corporations out of 85% active in the field of service.

On the basis of information about the length of a corporation's activity in the Slovak market, we classified chosen enterprises into three time intervals: less than 5 years, 5–10 years, and 10 and more years. The major groups of respondents were enterprises that have been running businesses for less than 5 years. There were 61% of businesses like that. The next two groups of enterprises are those that have been running business from 5 to 10 years (21%) and companies that have been on the market for more than 10 years (18%).

Small corporations, mainly micro-corporations, are vulnerable. Many of them cannot survive longer than 5 years. The research has pointed to the fact that strategic making decisions could be the key to survival and have the success of small and very small corporations.

[1]Classification based on Commission Recommendation 2003/361/EC effective from January 1, 2005.

Variable		Frequency		Percentage	
Number of employees	up to 9 10 - 49	175 35		83,33 16,67	
		0 – 9	10 - 49	0 – 9	10 - 49
Main activity	Services Commercial Production	148 21 6	26 5 4	84,57 12,00 3,43	74,29 14,29 11,42
Length of a corporation's activity in the Slovak market	up to 5 years 5 – 10 years 10 and more years	128 45 37		60,95 21,43 17,62	
Level of corporation´s activity	Regional Local National International	78 76 42 14		37,14 36,19 20,00 6,67	

Chart 1. The structure of investigated sample of small corporations. Source: Own processing.

Small corporations in our studied sample run business mainly on regional (37%) and local levels (36%): companies running their business within SR 20% and companies throughout EU 7%.

3.2. Research goals and research questions

The main goal of the research was to analyze the process of strategic making decisions in a theoretical and practical level and to outline the theoretical model of strategic making decision processes of small corporations. Being patterned on theoretical foundations and set goals of research, the following research questions have been formed whose answer will enable us to understand and identify the process of strategical making decision in small corporations.

Research question 1: Does the process of strategic decision making in small corporations lean toward an intuitive model of decision making?

Research question 2: Is the process of strategical decision making in small corporations mainly formed by external environmental factors?

Research question 3: Has emotional, cognitive, and social tendencies of their managers the major influence on strategic decision making in small corporations?

4. Research results and discussion

Within our study sample of 210 small corporations concerning their strategical decision-making processes, managers and owners of these companies consider future planning and self-development to be critical.

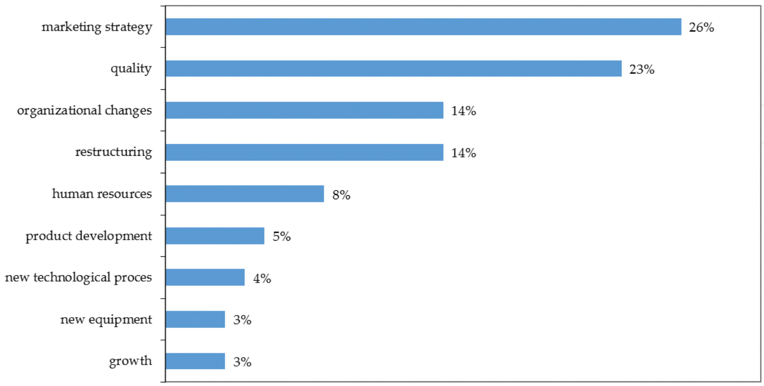
4.1. Strategic fields

The first question in our research involved areas limited to small corporations in Slovakia where the strategic decision making relies on and introduces the exact type of decision making within the period of the last 2 years. We have also asked which factors are the main triggers of the strategic process of decision making in their corporations.

The managers had defined more concrete problems which were divided into the groups that we can see in **Graph 1**.

On the basis of this knowledge, we have discovered several facts. The first one is the economic depression impact on strategic decision making even in small corporations. Rescheduling and organizing changes were represented in order to save costs because of economic depression. However, challenges relating to marketing strategy and its delimitation or appropriate selection of customers and their satisfaction dominated.

The explanation of this is that the employee's loyalty in small corporations is a bigger factor, informal relations dominate, and the managers do not have issues, for example, relating to human resources. That is why we would recommend to those corporations not to ignore the people and their competences in the business and also with a high accent to look at the problems of employees' development rather than how it has been in the past. In these spheres, advances in managing small corporations have been set up on quality as well as knowledge about well-founded decision making where necessary. It is more and more connected with higher and more intensive changes that are often unpredictable and managers, while they



Graph 1. The spheres of strategical decision making in small corporations in SR. Source: own processing.

make strategic decisions, have to also direct and assist employees, learning, and knowledge. It is necessary to encourage their employee's creativity, entrepreneurism, initiative, and ability to work in teams in order that everybody can be involved in customer satisfaction and company improvement.

Higher global competence, a move to an economy of knowledge and fast-shifting technology impact many aspects of work life in a small company. In the future employees with different professional qualifications, good working profiles and higher secondary and university degrees will be necessary in small corporations. The employees will need to improve their abilities and specialist skills.

The most expressively inadequate orientation has appeared in micro-corporations. Especially, they have to attract people with the highest qualification through the process of lifelong education at the company to get over problems. It is necessary to invest in electronic skills, to spread employment procedures for new groups of the population, and to develop the concept of feasibility and foster labor mobility.

It is also necessary so that managers are aware of the fact that the employees represent the most valuable company asset and that's why it is necessary to ensure the strong company cultural orientation for employee training and development plus the empowerment of individual workers. The company should create a pleasant incentive environment for their employees who have to have the possibility for self-development. They have to have an interesting job and be motivated in the most appropriate way. A functioning system is a guarantee of knowledge management.

Through the analysis of strategic areas of small corporations, we found certain reserves in strategic orientation for innovation and technological progress. At present, innovation is more important to survival and business prosperity than ever before. Markets have been changing rapidly and the competition of a developing economy (for instance, China and India) has been bigger and bigger. For small corporations, we can see a bigger challenge in carrying out research and development as well as accomplishing innovation than for big business. Small corporations often lack the financial resources needed to carry out research and therefore need to look for a competent business partner to create their own ideas and provide access to programs that result in innovation.

Innovation is not only a problem for small corporations in Slovakia, even in businesses of medium size and big businesses innovative activity lags behind most other EU countries.

The managers stated that the main reason for the formation of a strategic decision-making process within external resources primarily is their customers. The next "triggers" according to managers are the businesses internal resources. The replacement of employees by a highly qualified work force will give power to the manager and create new opportunities.

4.2. Rational decision making

Among the main criteria that allow us to explore the extent of the rationality behind the decision-making process, we have chosen five entries. These were proposed by Dean and Sharfman [7]

- search for relevant information when creating strategic decisions,

- analysis of relevant information,
- significance of quantitative techniques,
- efficiency of subject's decisions when processing information,
- the use of analytical and intuitive decision-making processes.

Search for relevant information is a significant element of the decision-making process, mainly because correct information forms the whole process and influences its final result. Information is the predisposition for conceptual and competent control and the ability to operatively influence the course of controlled processes and to flexibly react to the changing conditions in both interior and exterior entrepreneur environment. We have divided managers into two types based on their approach to decision making with low or high amounts of required information:

- Managers with maximalist approach (acquisition and analysis of great amount of information
- Managers with a satisfiable approach (only need key facts).

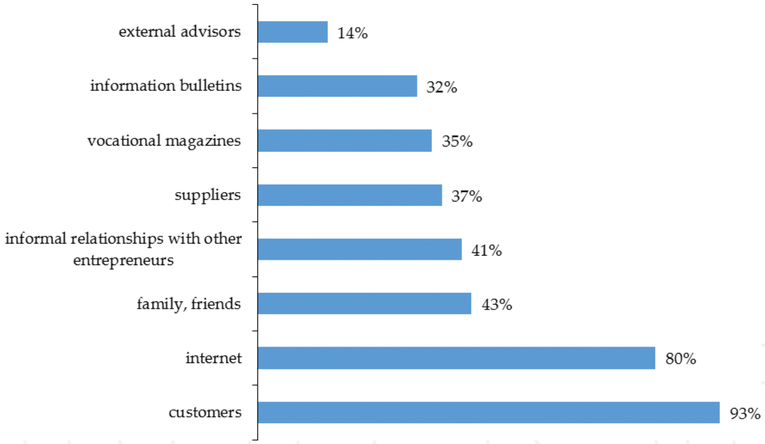
The first group is made by managers, called maximizers. Their goal is to search, accommodate, and restlessly look through a mass of data, before making a decision. The result of their work is a well-informed decision; however, it may be time costly and lack effectivity. This group of managers represents 25% of the whole count. The second group is composed by managers, who only need the key facts, and if these satisfy their conditions—they decide. We call them satisfiers (managers optimize the amount of information). In our research group, these represented the 75% group.

It is obvious that managers of small corporations are more likely to incline to a restricted rational model of the process of decision making, it comes from partial information, which is sufficient for a satisfying decision. The maximization of effectiveness is not always a primary concern in these businesses.

In the fields of information search, we were concerned about their resources, meaning: where do managers get their Intel from. Our research was based on their division into internal and external strategic information. Internal, the one that comes straight from within the business (information about the sources of the business and their use also information about borderline situations experienced in the business, etc.) The source of this information is the staff/business itself. External information is gained from a businesses' external environment, for example, press, analyses conducted by advisory companies and organs of the state, information from suppliers, customers, and so on.

A question was opened, to allow the gain of deeper insight into ways of collecting information. The most usual answers were: "I regularly look through my internet resources," "I read vocational magazines, to keep myself up to date," "I often take advice from my family," "I monitor the demand of my clients"; some answers appeared several times, others were exceptional. The overview is shown in **Graph 2**.

The results lead us to the fact that small corporations in contrast with big (which dispose with a vast source for systematic global, and targeted monitoring) have a much worse situation



Graph 2. Sources of information for managers. Source: own processing.

to handle in this field. Their ability to gain information is significantly reduced in financial, human, material, and technological areas. The greatest source of information for these businesses is customers. A total of 93% of researched businesses see their main inspiration in customers and their feedback. Thus, the main principle is to stay close to customers and adapt strategical decisions to the demand. The next significant source is the Internet, which is nowadays a common part of an entrepreneur's life. Then, with the same approximate representation come vocational magazines, friends and family, informal relationships, and everyday dialogs with other entrepreneurs. Only a small percentage of managers (14%) claimed to use external advisors, due to the shortage of funds.

Information required for strategical decision making of small corporations comes mainly from external sources. It is required to note that search for information is not mostly conducted on a systematic basis. It is based on random occasions; it is time and resource restricted, and considerably subjective. We can state that the methods of searching and amassing information show the application of a restricted-rational model of strategic decision making of small corporations overlapping certain features of the intuitive model, in which the gain of information is affected by approaches, ideas, and resolutions of the manager himself/herself.

When analyzing and processing information, managers followed up in responses to the previous question of gaining information. The nonexistent means for extensive databases, statistical and quantitative analyses, report on both financial and expert level, and restrict efforts put in decision making from reaching maximal value from the information. The problem of effective decision making can also be the fact that managers are overwhelmed with information, and they cannot process them and use them to effectively support the decision-making process. From the results of our research, we have ultimately discovered the lack of correct and clear presentation of information.

Many managers still control and decide as if there was no worldwide computer grid. This problem has several aspects. First, the use of clear intuition is too common; it is substantiated too often by managers' experience. Second, there is only a very weak link between bits of information that are really accessible to the manager, and the decision that he/she makes.

Ultimately, such analyses are ignored in favor of the institution and comfortable, old practices. Most of the small corporations do not know what their best decisions were and how could information and technologies be used to make those decisions more informed. Our results coincide with other researches [17, 24], showcasing the absence of analytically based managers, trend of using ad hoc approach, the usage of approach based on experience, and behavioral-based evidence.

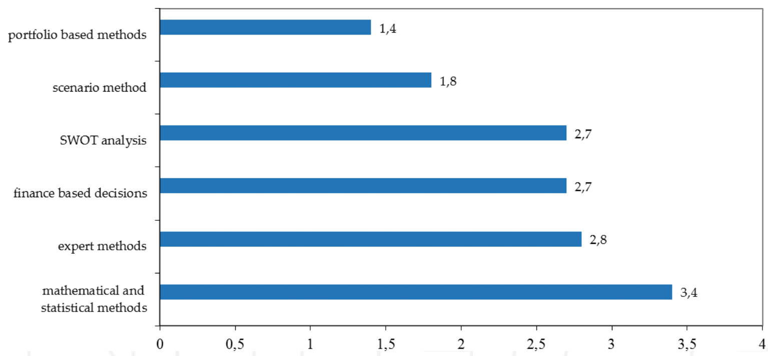
Another dimension within the examination of strategic decision-making process in small corporations referred to the creation of opportunities, which we based on four styles of decision making of managers [25]: decisive (little information, one direction), hierarchical (much information, one possibility), flexible (little information, many possibilities), and integrating (much information, many possibilities).

Managers in our test sample were supposed to place themselves into one of the four given types based on the amount of information and possibilities. The most frequent style of small corporation managers was decisive style—meaning that the managers stated need for less information and narrow focus when it comes to selecting options. Such managers recognize rapid action and effectiveness and consistency in the absence of time and resources. Their choice is linked to overall search, collection, and information-processing processes, which they stated in previous statements, and to sufficient "satisfactory" search options within decision-making process.

Flexible style is the second most common. However, its representation is significantly lower and managers who identified it as used by them use it properly, in times of relative uncertainty, when there is need for quick changes of direction, based on the change of conditions. Hierarchical style is regarded as highly analytical, explaining its small representation in our test sample. Integrating style did not occur in the sample. This style requires many inputs, time, constantly opened information flows, a wide range of views, including contradictory ones, and mostly gives just framing of decision situation with multiple possible solutions considering changing conditions in complex, dynamic, and turbulent business environment during the global crisis.

To assess a model process of strategic decision making (in the sense of assessing its rationality), it was required to research also the use of varying (mostly quantitative) methods and techniques used for deciding (**Graph 3**). Acquaintance and intensity of usage of each decision-making method was rated by managers on a scale from 1 to 5 with the following contextual definition: 1, unknown; 2, known but unused; 3, known, used rarely; 4, known, used occasionally; and 5, known used often.

By studying **Graph 3**, it is clear that not only the usage but mainly the knowledge of basic methods is very low when it comes to small corporations. Our opinion is that the reasons are several. One of them being the all-around knowledge of statistical methods (that also being because of the reason of technical education on many managers). Their use is inexpensive, easy, and time effective. In favor of exact methods is also the fact that a part of them is simply integrated chart processors with tools to analyze, communicate, and to share results. Via this,



Graph 3. Usage intensity of decision-making methods by managers. Source: own processing.

we can also explain the tendency to not use, or rather not know specific managing methods. Then again in case of knowing these, it is characteristic to lack practical experience with using such methods. Another reason is obviously the impracticality of some methods in certain sections of control. The usage, or rather the resting of some software to support decision making, is conditioned by financial and human resources. A manager of a small corporation is not capable of maintaining the required level of expertise in several fields at once.

Based on found results, we can state that the process of strategic decision making in small corporations inclines to a restricted-rational model of decision making, which is restricted by time and funds. It is limited by expert capabilities of managers, it works with deficient information. Information is gained unsystematically, randomly, or based on informal business or social relations and customers' demands.

4.3. Judgment

Another field that we surveyed at managers in order to determine the type of strategic decision making was an area of Judgment. Judgment represents a mental activity, which is also participating in solving problems and decisions. Judgment is the process through which we think about, form our opinions, achieve conclusions, and critically assess actions around us; it is based on an available information and also is a source for decision making.

Managers were asked about their way of judgment to find out specific facts, situations, and events from which we could derive certain conclusions within the meaning of determining the model of the strategic decision making.

Managers in their responses state: "when thinking I use method of trial and error, when thinking I use my own experience and intuition, I had an idea that….. I felt, it should be so, I woke up and suddenly I knew what to do, it was my spontaneous idea, unexpected formation of my thought" and so on.

The feedback is clear that the dominant model is intuitive model. Managers on a regular basis possibly every day act without apparent use of all relevant information that is available from the environment and their memories. Even if they are aware of all the details, they necessarily do not investigate them deeply and do not always give the appropriate importance, before the decision. On the contrary, they often deal with the first what they think of. It usually occurs without some apparent effort and they cannot answer the question of why they come up with such a proposal. Managers often tend to trust their intuition, simply because it is quite successful in some cases. It seems like it is possible for them to be satisfied with intuition in many situations.

Certainly, we must point out on supportive opinion about intuitive decision making, mainly in small corporation managers. These people do not have time to compare, logically and systematically, all available options. They are learned to make decisions in a certain way, which has worked and saves time so far. On the basis of associations with different designs and past experiences, they assess the situation and almost immediately act on the grounds of experience and intuition. The major advantage is the ease, speed, and parallelism.

However, change of minds is so difficult and slow. Intuitive judgments may or may not be correct and controlled. It is significantly impacted by various inclinations, tendencies, abbreviations, and heuristics. In this case, the best way of how to control the intuitive judgments is by rational mental processes, which is more demanding of time and effort.

This is why many authors point this when they talk about counter-arguments [26–28] and many others. "Faith in intuition is understandable, because people always search for mystical powers for direction of their faith" [26]. It adds that intuition has its place in decision making, but "anyone who thinks that intuition is a substitution for logical thinking, it is only risky devotion of self-deception. Intuition is unstable and independent leader that will easily lead you to success but also to a catastrophic disaster" [26, p. 117]. Therefore, intuitive decisions require years of experience and learning of facts, situations, concepts, procedures, and abstractions that are stored in the human brain.

4.4. Emotional, cognitive, and socially conditioned tendencies of managers

In a small company, and even more in micro-corporations, the personal characteristics of the decision maker have a significant impact on the decision-making process, because in most cases the decision making is domain of only one (the owner-manager) or two people. Heuristics, deviations of rationality, or emotions of managers can suppress the whole decision-making process and bring him/her into the wrong end.

It was not very difficult to investigate the emotional, cognitive, and other socially conditioned tendencies of managers on account of the structure of research. For a deeper understanding, as the object of the research, it would be preferable to choose individual decisions in a smaller number of enterprises that have a wide variety of problems. It may arise in the decision-making process from which it is possible to create specific, different influences of emotions, personality characteristics, heuristics, prejudice, deviations from rationality, ethical values, and so on.

Managers were asked a few of questions to determine the above tendencies. Answers were acquired in the form of a controlled interview, so the meaning of the questions would not be misunderstood. It was about questions like: Do you prefer the experience or an advice of an external consultant? Would you prefer a lucrative sale of the company or continuation of the enterprise in order to achieve personal goals? Would you rather employ foreign workers who are cheaper at the expense of domestic workers? If you are under stress, do you make a decision or try to move it a little later? If you have made a decision, have you ever wondered what it would be if you chose another option? In bargaining, do you prepare specific proposals before the meeting or you wait for proposals of counterparty? Does it influence you in decision making any various past events, trends, or old information? During decision making, do you consider to decide tomorrow maybe later or do you take an action immediately? Can you relieve from sunk costs (economic or psychological) in your decisions? Have you ever wondered whether in collection of information you emphasis on information that confirm your statement or to conflicting information?

The answers of managers were evaluated and we came to the conclusion that the influence of the abovementioned effects of the decision-making process is visible. It is indicating the dominance of an intuitive model of decision making associated with their intuitive strategic thinking which defined [29] as a thinking which operates according to the main article and the whole is assessed on the basis of selected central element.

5. Conclusion

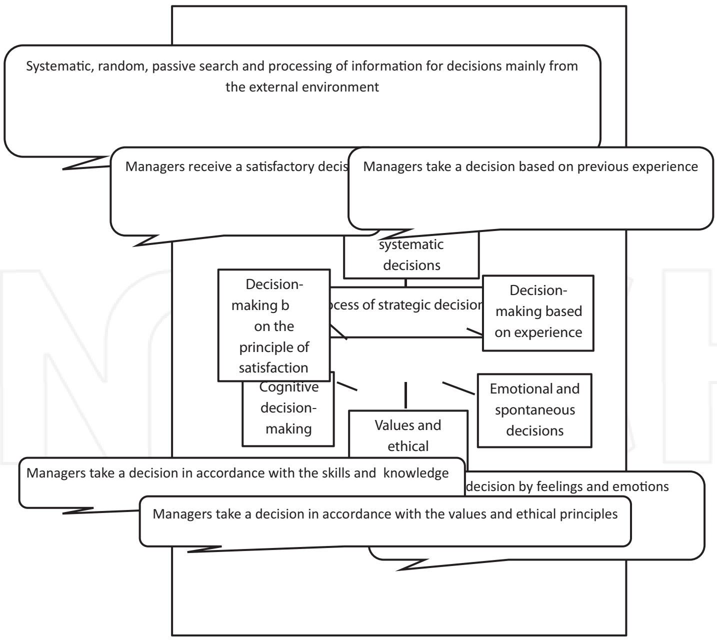
Strategic decisions are usually complex by its nature and try to change the overall scope of authority and the direction of the company, as opposed to simple, routine decisions which are intended to provide a competitive advantage. It relates to the different areas and its effective recruitment has a crucial importance for small and large businesses, since strategic decisions significantly affect business performance. However, research and studies focused and are still focusing mainly on large companies, while there are significant differences between the process of strategic decision making in large and small companies. It causes that the application of theory and research of large companies to small company is limited.

An implemented research allowed us to verify stated research questions. Research question 1 was partially answered. The process of strategic decision making in small corporations mostly tends to intuitive model approach of decision making. Simultaneously, it also appears the elements of limited rational model approach combined with certain characteristics of incremental and decreasing model of strategic decision making. Limited rationality is impartial in small corporations; worse thing is that in these enterprises it is also a consequence of the lack of quantitative analyses, the low level of knowledge, and the use of analytical tools. The answer to the second research question is: the main factor that is formative in strategic decision making in small corporations is customers. The third research question about the effect of experience, ethical aspects, emotions, personal characteristics, and subconscious information processing in taking strategic decisions was also answered.

Strategic decision making in small corporations takes place as a process of non-systematic, random, and passive searching for information largely from the external environment, which lead to the adoption of acceptable or "fairly good" decisions compared to the decisions with maximum effect. Managers accept the value and ethical decisions based on previous experience, affected by feelings and emotions. They subconsciously make decisions on the basis of skills and knowledge.

Based on the analysis of the theoretical basis and research results, we can include the main aspects influencing and forming process of strategic decision making by managers of small firms, shown in **Scheme 1**.

Although the global economic crisis sharply hits small corporations, just these react so sensitively to the economic recession and on the other hand are much more adept in an effort to rescue as larger enterprises. Small corporations cannot afford crews and teams of specialists who would dedicate exclusively to the issue of decision making at the strategic level and apply its principles and procedures. However, they can improve their implemented process of decision making and turn their "shortcomings" over the process running at large enterprises for the occasion. Great competitive advantage, which is given in the research, is the proximity to the customers who can systematically and through supporting implements of decision making use the opportunity to improve the process. The challenge for the improvement may be a significant influence of personality traits manager in approving decision making. Purposeful development of managerial skills using a variety of tests and procedures, to regain consciousness of the existence of certain tendencies and preferences, you can better manage the economical psychological tendencies and detect errors before they affect the final decision. By greater focus on the internal resources, particularly for people to encourage their creativity and entrepreneurial spirit it is possible to improve the quality and effectiveness of the entire process of strategic decision making.



Scheme 1. Aspects of the strategic decision making in small corporations. Source: own processing.

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Chapter 5

Taking Corporate Social Responsibility as Growth Strategy

George Y. Wang

Additional information is available at the end of the chapter

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Abstract

Corporate social responsibility (CSR) has been of great interest to many practitioners and researchers. Although this topic has been in hot discussion for the past few decades, many concerns and debates remain. In recent years, increasing evidence has demonstrated that there exists a positive relationship between CSR and firm performance, which negates conventional thought that CSR is an unavoidable additional cost to a firm. In fact, CSR can facilitate a positive value of a firm from the perspectives of marketing, innovation, management, and ownership. Thus, this chapter argues that CSR should not merely serve for the window-dressing purpose, yet it should be incorporated into practical business operations and then become key corporate growth strategy as a firm grows in size.

Keywords: corporate social responsibility (CSR), corporate social performance, stakeholder, growth strategy

1. Introduction

Ever since market economy becomes the dominant economic structure, maximizing shareholder wealth or corporate value has been the major corporate goal for management. The goal of value maximization describes that in the world of no agency cost, management would make the best corporate decisions in an attempt to maximize shareholder's wealth or corporate value. In the presence of managerial agency cost occurring to a firm, the goal of value maximization is compromised by agency cost due to management's self-interest [1]. Nevertheless, value maximization continues to serve as the top-priority corporate goal in the prominent economic system of market economy. Take, for example, the JX Group, the parent company of the largest petroleum firm in Japan, ENEOS. In their 2013 Annual Report, organizational restructure was explicitly strategized to aim at maximizing the corporate value of their group, which was described as the ultimate corporate goal.

When the corporate goal of value maximization is formulated into a publicly listed firm, the goal is often extended to maximize stock price. Both corporate goals prevail over the other views of business philosophy in the current dominant market economy. More frequently, value maximization is referred to as the core concept of "shareholder capitalism." In the classic principal-agent relationship between shareholders and management, shareholder capitalism protects the shareholder's interest toward the firm, which is not explicitly described in the business contracts when dealing with management.

Although value maximization has been the major objective function of management for a long time, contrast to shareholder capitalism, the perspective of "stakeholder capitalism" has also gained significant votes of advocacy. The inception of this perspective can be traced back to Henry Ford's time, in which he said, "there is one rule for the industrialist and that is: make the best quality of goods possible at the lowest cost possible, paying the highest wages possible." Clearly, the stakeholders that Henry Ford was referring to were employees of a firm. According to Freeman [2], in the contemporary business world, stakeholders are spread out to "any group or individual who can affect or is affected by the achievement of the organization's objectives."

In recent years, a related concept to stakeholder capitalism, corporate social responsibility (CSR), has been of great interest not only to financial economists, but also to corporate practitioners. Although CSR has quite a variety of definitions,[1] the consensus is that corporate behavior can no longer be examined from the single dimension of value maximization. A firm is expected to take more responsibilities to the economy as well as to the society. That being said, corporate goals should be extended from enhancing corporate growth in value maximization to developing social growth. Carroll [4] proposes a pyramid model to describe these responsibilities, that is, economic, legal, social, and philanthropic, from bottom to top.

The infusion of CSR into corporate goal has become the new element to examine the performance of a modern business, yet the debate over CSR is still ongoing even recently. Take, for example, Milton Friedman's famous argument. Friedman [5] argues that in a free economy, there is one and only one social responsibility of business to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game. Apparently, Friedman defines that the goal for a firm is to fulfill its economic and legal responsibilities. By contrast, Carroll [4] proposes a pyramid model that management should aim to meet four levels of corporate social responsibilities, i.e., economic, legal, ethical, and philanthropic responsibilities. This model is clearly a more far-reaching extension than Friedman's argument. Based on the agency theory, Jensen [6] contends that management's self-interest cannot guarantee value maximization since corporate value will be offset by management's agency cost should proper incentives not be provided. Hence, value maximization is still the major driving force in a market economy given that stakeholder's interest is taken into account and that the trade-offs to compensate these interest are made on the condition that management is provided proper incentives. Recently, Porter and Kramer [7]

[1]According to Carroll [3], there are over 25 different ways to define CSR in the literature.

have proposed that a firm should make every effort to create shared value by taking the interest of all the stakeholders into account. Thus, CSR should be considered an important corporate strategy.

Along the line of CSR research, this chapter intends to take one more step by arguing that management's CSR mindsets can serve as a driving force for corporate growth. Thus, CSR is no longer a by-product, in addition to the fundamental legal and economic responsibilities of a firm, instead CSR becomes one of the key corporate growth strategies. In the rest of the chapter, we discuss CSR theories and dimensions, elaborate on approaches to CSR measurement, present evidence for the relationship between CSR and firm performance, and finally elucidate why CSR should be viewed as one of the key corporate growth strategies.

2. Theories of corporate social responsibility

Since CSR has become a new focus in the theory of firm, researchers have attempted to formulate the CSR theory from different perspectives. Winsor [8] suggests that there are three major approaches to CSR: (1) ethical responsibility theory, which advocates strong corporate self-restraint and altruism duties to strengthen stakeholder rights; (2) economic responsibility theory, which argues that a firm aims to maximize its market wealth with the side effects of minimalist public policy and perhaps customary business ethics; and (3) corporate citizenship theory invokes a political metaphor providing neither true intermediate positioning nor theoretical synthesis.

Mele [9] considers the evolution of CSR studies and then summarizes four major CSR theories. The first one is based on corporate social performance (CSP), which is basically built on sociology. Sethi [10] discusses the dimensions of CSP, in terms of corporate behavior, can range from social obligation, then social responsibility, and social responsiveness. According to Wood [11], CSP means a change of corporate behavior from conventional value maximization to produce less harmful and more beneficial outcomes for the society and the people. Therefore, CSP is defined as the configuration in a firm, which includes the processes of response to social requirements, and the policies and programs reflecting the firm's relations with the society. According to Wood [12], the weaknesses of CSP theory are its vagueness in practical contents and its insufficient linkage between ethical normative aspects and business activities.

The second CSR theory is shareholder value theory (SVT), which has been the dominant view in financial economics. The SVT describes that corporate behavior should aim to maximize corporate profits in the short run and shareholder's wealth in the long run. In this definition, the CSR actions in a firm should be directed to fulfill its economic and legal responsibilities [5]. On the ground of the SVT, the impacts of corporate behavior and business activities on the society are out of consideration. In addition, the relationship between agents (management) and stakeholders is not fully addressed. Due to these weaknesses of SVT, Jensen [6] proposes a revised social value, although he still advocates value maximization in the corporate objective function.

In contrast to the SVT, the stakeholder theory takes into account the interest of all the stakeholders surrounding the company [13]. While shareholders certainly are an important group of stakeholders, other corporate stakeholders would include managers, nonmanagerial employees, suppliers, customers, communities, governments, and social and environmental groups. Another characteristic of the stakeholder theory is to achieve global sustainability, which is defined as the ability to meet the needs of the present without compromising the ability of future generations to meet their needs. It refers not only to a sustainable social and natural environment, but also to sustainable capitalism [14]. With regard to weaknesses of the stakeholder theory, Jensen [6] argues that the stakeholder theory is incomplete and unattainable due to its failure to provide appropriate incentives to management, in particular, in a market economy. Furthermore, should the stakeholder view be adopted in corporate policies and practices, it may become a legitimate excuse for management when he fails to meet social responsibilities as well as achieve value maximization [15].

The last CSR theory is to take a perspective of corporate citizenship (CC). Carroll [3] argues that a firm acting as a good corporate citizen should actively engage in acts or programs to promote human welfare or goodwill. In his famous pyramid model, corporate citizenship is considered to be philanthropic responsibilities, which "reflects global society's expectations that business will engage in social activities that are not mandated by law nor generally expected of business in an ethical sense" [16]. Furthermore, Matten and Crane [17] and [18] suggest that CC can be seen as an extension that compensates the view that CSR is an external affair to a firm. In addition, CC also contributes to define the codes of ethical conduct in a firm. However, the usage of "citizenship" is a relatively narrowed definition with enforcement power to a firm with regard to fulfilling its social responsibilities. Also, CC implies legitimate obligations of a corporate citizenship, while the existing conceptual CC framework fails to address corporate rights in order to balance the requirements of citizenship [9].

Until recently, the CSR theories still continue to prosper from several theoretical aspects. Although the four theories are presented in an equal way, this does not mean that these theories are equally accepted by practitioners and academics. In general, CSP and CC are considered to be biased toward corporate responsibilities from the perspective of practitioners, yet the stakeholder theory, in general, gains more support from both researchers and practitioners. In short, the CSR theories are still fast developing and may be in debate in certain areas.

3. Dimensions and measurements of corporate social responsibility

From the practical point of view, Carroll [3] defines CSR as four bottom-up responsibilities, that is, economic, legal, social, and philanthropic responsibilities. This definition clarifies the scope of CSR yet provides less practical implications in CSR contents and measurements. As societal expectation toward the fulfillment of CSR has become increasingly vocal in the global context, international institutions or organizations not only regard CSR as a new requirement of a responsible firm, but also take actions to evaluate corporate social performance. For instance, in 1999, Dow Jones, Stoxx, and Sustainability Asset Management Co. constructed the Dow Jones Sustainability World Indexes (DJSI World) and formulated evaluation criteria to compute stock performance of selected socially responsible firms. The screening standards of DJSI World were built on a firm's contributions to economy, society, and environment. Now these three dimensions have become a popular operational framework for appraising corporate social performance (CSP). For example, Wang [19] proposes CSR to be a new approach to style investment, constructed a CSR index (CSRI) to form social funds, and finds that social funds could significantly outperform the market portfolio (index), yet still underperform the conventional value portfolio.

As mentioned earlier, among the four CSR theories, the stakeholder theory suggests that the interest of all the corporate stakeholders should be equally considered in the CSR. Freeman [2] defines stakeholders as "any group or individual who can affect or is affected by the achievement of the organization's objectives." According to Donaldson and Preston [20], corporate stakeholders include not only shareholders, managers, employees, suppliers, and customers, but also government, social groups, environment groups, and communities. Maignan and Ferrell [21] and Maignan et al. [22] argue that the implementation of CSR would enhance marketing advantages and reinforce corporate identity of stakeholders. In general, corporate stakeholders can be classified into primary and secondary stakeholders; the former stakeholders are referred to as those who engage in transactions with the firm, have influence on it, or are influenced by its decisions; the latter stakeholders are defined as those who have influence on the firm or are influenced by its decisions, but are not essential for its survival [23].

Along the ample CSR literature, one important line of research looks to examine the relationship between CSR and firm performance, frequently regarded as the CSR-performance puzzle. The empirical literature on the CSR-performance puzzle suggests inconclusive results; some studies find a positive relationship, while others report a negative or no relationship ([23], Ch. 17). For instance, Mahapatra [24] examines how external investors evaluate a firm's efforts on pollution prevention and suggested that external investors behave as rational economic investors instead of ethical investors, revealing that the high expenses of pollution prevention in a firm may harm its stock performance. McWilliams and Siegel [25] find that CSR has no significant influence on firm performance. By contrast, several studies (e.g., Refs. [22, 26–28]) find that the effects of CSR on the firm could be accumulated and reinforced positively in the long run, thus leading to a better firm performance.

Earlier research on the CSR-firm performance relationship is mostly based on qualitative approaches such as inferences, expert interviews, case studies, and survey studies. The major disadvantage for this line of CSR research is that qualitative methodology tends to be somewhat arbitrary when drawing managerial implications. In addition, CSR literature thus far finds less strong empirical support in measuring a firm's contributions to CSR and thus in finding statistically significant conclusions.

Of the relatively insufficient literature in quantitative CSR studies, Wang [19] constructs a CSRI for measuring corporate contributions to CSR by integrating the stakeholder theory and the three dimensions of Dow Jones Sustainability Index (DJSI). The CSRI consists of three dimensions, i.e., economic, social, and environmental, under each of which contains the interest of related stakeholders. Several operational variables are constructed to measure firm's contributions to these interest. Each data point within a variable is converted into a percentile score. The CSRI is then computed by these scores of three dimensions. The study finds that over the period of 2001–2009, the high-scored CSR portfolio outperforms the rest of the competing portfolios, including the growth and market portfolios, except for the value portfolio. The study shows socially responsible firms outperform the other firms in the stock market. When a firm makes efforts to fulfill its social responsibility, it not only improves its social performance, but also attracts interested investors to buy and hold their stocks, thus leading to a relatively better stock performance.

Wang [29] regresses the three-dimensional CSRI on the performance measures, e.g., q ratio, profitability, and stock return, and finds that when a firm fulfills its corporate social responsibility, the firm has a better performance in corporate governance and profitability, thus reflecting a better operating performance. Furthermore, the statistical results indicate that the fulfillment of CSR has a positive impact on firm value and stock return. This study concludes that although CSR projects may increase firm's costs and expenses, yet the benefits of engaging CSR may exceed its costs, therefore, resulting a positive impact on firm performance.

Wang et al. [30] examine the relationship between CSR and firm performance with the approach of quantile regression. Their findings imply a nonlinear relationship between CSR and firm performance, to be more specific, the effect of CSR on firm performance for a high-return firm is more significant than that for a low-return firm. Both findings are consistent with the conclusions in Refs. [22, 26–28, 31].

Wang et al. [32] explore how CSR would impact on corporate image and found that there exists a significantly positive relationship between CSR and corporate image. The implication of this study is that there are no conflicts between the goals of maximizing corporate value and fulfilling corporate social responsibility. Management should regard the implementation of CSR as corporate investments and competitive advantages, which would improve corporate image as well as firm performance.

Wang [33] applies the approach of quantile regression to investigate the relationship between corporate governance, specifically ownership structure and board composition, and CSR. Based on empirical evidence, it is found that ownership structure may have a significant impact on CSR. Furthermore, the shares owned by major stockholders, institutional investors, and management increase with the degree of CSR implementation. Of the three types of stockholders of interest, management is found to have a relatively large impact on CSR, explained by their influential power in corporate operation and reduction in agency cost. Board composition plays an important role in committing to CSR. In particular, as the number of outside directors and the shares owned by outside directors increases, firms seem to increase their contributions to CSR. Also, the evidence shows that board size has a negative impact on CSR. As board size gets larger, board members' opinions toward CSR may be diverse, thus discouraging the fulfillment of CSR.

Wang et al. [34] explore the impact of corporate governance on CSR by a panel data analysis. Based on a large set of panel data with 722 firms in the period of 2005–2011, it is found that corporate governance has nontrivial individual and time effects on CSR and that the causal relationship is statistically significant.

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The preceding literature provides several important insights into the CSR research: first, from the practical perspective, CSR consists of three major dimensions, i.e., economic, social, and environmental, which is also an internationally accepted operational framework. Some studies regarding corporate governance as the fourth dimension for corporate governance are highly correlated with CSR and have now become a critical aspect to examine CSR. Second, contrast to qualitative approaches, quantitative research is yet to be documented due to data unavailability. A good example is that corporate donations are considered to be an effective indicator of corporate social performance, but donation expenses are neither disclosed in financial statements nor required to be transparent by laws. Third, of the relatively less amount of empirical studies, CSR is found to have a positive impact on firm performance, which provides a managerial implication that CSR programs as a whole are not necessarily regarded as an expense to a firm, but a profit driver instead.

4. Corporate strategies in response to CSR

As described in Ref. [23] (in Ch. 17), since regulatory pressures underpin formal institutions and normative, and cognitive pressures support informal institutions, the institution-based view sheds considerable light on gradual diffusion of the CSR movement and strategic responses of firms. According to Hoffman [35] and Peng [23], when a firm is involved with the CSR issues, firm's strategic responses tend to fall into the following four corporate strategies: (1) reactive, (2) defensive, (3) accommodative, and (4) proactive strategies.

A reactive strategy is referred to as the situation in which a firm's top management gives relatively little or no support with regard to CSR issues. When a firm takes a reactive strategy toward CSR, management is not compelled to respond to any CSR concerns. When any CSR-related problems, such as disasters and outcries, arise, defensive or denial actions are generally the frontline of response. With this strategy, the firm has neither internalized any actions nor initiated programs related to CSR. Furthermore, management has not formulated any norms or code of conducts in practice. In this situation, legal or regulatory power is therefore required to coerce firms to comply with minimum regulations. For example, in September 2015, the United States Environmental Protection Agency (EPA) issued a notice of violation of the Clean Air Act to German automaker Volkswagen Group. The agency had found that Volkswagen had intentionally programmed turbocharged direct injection (TDI) diesel engines to activate certain emission controls only during laboratory emissions testing. The programming caused the vehicles' NOx output to meet US standards during regulatory testing but emit up to 40 times more NOx in real-world driving, thus named as "Volkswagen Emissions Scandal." Volkswagen deployed this programming in about 11 million cars worldwide, and 500,000 in the United States, during model years 2009 through 2015. The management insisted on this event was simply wrongdoing by a few employees-in-charge. However, according to the authority, these emissions "defects" were fabricated ever since 2009 and thus it was hard to believe that management was totally unaware of the presence of these so-called defective devices. In the end, the firm was faced with several legal charges and more importantly lost hard-earned consumer's trust.

A defensive strategy focuses on meeting regulatory compliance. With this defensive strategy, management targets at complying with regulatory requirements so that the firm can be relieved of regulatory pressure. Also, CSR activities are considered as additional cost burdens to business operation and management's involvement in CSR is very limited. The regulatory requirements are thus at significant odds with the norms and cognitive beliefs held by the industry. A good example is that, in 1991, Japanese recycling law set industry standards to make electronic products easier to disassemble. Although Hitachi initially resisted the law, the firm eventually responded by redesigning products to simplify disassembly in order to protect its market share. In the end, the company was able to reduce the parts in its washing machines by 16% and in vacuum cleaners by 30%. These electronic products became not only easier to assemble/disassemble, but also cheaper in terms of costs of goods sold, thus providing Hitachi with a significant cost advantage.

Both the reactive and defensive strategies are considered as passive strategies, in which firms are not voluntarily engaged in CSR activities. Consequently, firms responding to CSR concern with the two strategies may make a controversial argument that excessive regulatory pressures or governmental regulations in environmental protection, food safety, or other areas may result in increasing operational cost and thus lose competitiveness to foreign competitors which are subject to less demanding regulations. However, economists generally would argue that these governmental regulations simply force firms to pay real costs that they otherwise place on others. If a firm pollutes, it is imposing a cost on the surrounding community that must either live with the pollution or pay to clean it up. By imposing a pollution tax that roughly equals the cost to the community, the firm has to account for pollution as a real cost, meaning to internalize a negative externality.

An accommodative strategy is defined that management may take a positive view toward CSR activities and thus is willing to partially participate in these activities or invest some corporate resources in them. When taking this strategy, managers may accept the fact that CSR is a fundamental corporate responsibility and thus becomes to form the mindset that CSR is legitimate and social obligations to society. For example, in 2007, Marks and Spencer determined not to purchase endangered species of fish in its famous CSR program "Plan A" by signing a contract with its seafood suppliers, which in turn led to the effect on preserving precious ocean resources.

Another corporate strategy in response to CSR is a proactive strategy, which is characterized by adopting a set of written corporate policies that includes a firm's acceptance of CSR. In this situation, CSR has legitimacy to become management's major agenda, as well as formal corporate duties in practicing CSR. Furthermore, management taking this viewpoint is willing to proactively conduct CSR programs at the expense of more current corporate profits to reach a long-term "shared value." From a CSR perspective, the firms take a proactive strategy when engaging in CSR, constantly anticipating their responsibility and endeavoring to do more than is required. For example, ice cream maker, Ben Jerry, not only has adopted recycled packaging on its products and redesigned its dairy farms to become more environment-friendly, but also commits to donate 15% of its net profits to charities and foundations.

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Both the accommodative and proactive strategies are considered to be a sustainable strategy, supported by management. With this sustainable, supportive strategy, more firms nowadays are willing to voluntarily publish an annual CSR report, which embraces the strategy into corporate philosophy, mission statement, and business practices. Furthermore, firms with more social conscience also indicate willingness to participate in discussion with community groups or nongovernment organizations (NGOs) and work with these traditional “enemies.” Taking one more step, some firms taking the proactive strategy voluntarily include the global standards in CSR into their whole business practices.

As more empirical evidence has indicated a positive relationship between CSR and firm performance, invalidating the conventional view that CSR is conducted at the sacrifice of corporate profits. Instead, engaging in CSR activities can in fact lead to a better firm performance, which thus leads to a new corporate strategy-growth strategy. Put another way, committing more social responsibilities can not only provide some tangible social and environmental benefits, but also generate long-term corporate benefits, which may exceed short-term expenses. Take, for example, the International Standards Organization (ISO), which is an influential international NGO and headquartered in Switzerland. In 1996, ISO launched the certification program of ISO 14001, which encompassed the environment management system (EMS) aiming to protect worldwide environment. The EMS of ISO 14001 was a rigorous attempt for environmental protection and has become the golden standard for CSR-conscious firms. Although not required by domestic laws, many international firms, such as Toyota, Siemens, and General Motors, have not only adopted ISO 14001 standards in all their facilities worldwide, but also requested all of their major suppliers be ISO 14001 certified.

Are these firms doing this just because they take a proactive strategy? Obviously not, they are doing this to pursue long-term corporate growth by maintaining a sustaining environment. In today’s global business environment, the management of these firms has to face with multiple stakeholders and their corporate decisions have to respond to the multiple needs of the stakeholders. Since management must commit to pursue social growth and corporate growth at the same time, it is therefore logical to integrate CSR into corporate growth strategy.

5. Conclusion

As increasing empirical evidence finds that there exists a positive relationship between CSR and firm performance, one might wonder how CSR can generate a positive value to a firm. Business practices from successful firms shed light on several managerial implications: first, CSR activities may serve as a good marketing program to improve corporate image and thus increase sales revenues. For instance, the British retailer, Marks, and Spencer, initiated a “Plan A” campaign since 2007, aiming to change 100 things to protect the world we live in. Within 3 years of time, this new campaign has successfully boosted the firm’s sales revenues over 20%.

Second, CSR may provide encouraging motivations for product or production innovations. For example, Nike, once accused of sweatshop with the use of child labor, adopted new fabric materials made of recycled plastic for high efficient sports clothing. This new campaign not only significantly improved corporate reputation, but also increased sales in the sports apparel market. In addition, French airliner Air France-KLM initiated a project to reduce carbon dioxide by 20% per passenger by adopting newly developed biofuel. This project has not only maintained its fuel cost at the long-term sustainable level, but also reduced in-cabin noise during the flight.

Third, CSR activities may serve for the purpose of business management. The famous US supermarket chain, Costco, paid over $20 per hour to its employees, which exceeded the double of national average on hourly wage. In addition, the firm provided over 90% of its employees with medical benefits. With high employee's satisfaction and commitment, the firm operated with a low turnover rate less than 15%, which not only obviously reduced explicit and implicit training costs, but also significantly raised employee's productivity, leading to record high net corporate profits in 2014.

Last but not least, CSR activities may attract interested investors to maintain long-term ownership so as to enjoy long-term stock return. Wang [19] demonstrates that a portfolio including CSR stocks may empirically outperform conventional style portfolios, such as market and growth stocks, in the long run.

In conclusion, since each firm can vary in terms of corporate in resources, investment size in CSR may be different. In general, large firms may have more economic resources and influence on conducting CSR activities than smaller firms. As firms continue to grow in size, more CSR activities incorporated into business practices become increasingly important. In the end, CSR should not just serve for the window-dressing purpose, yet it should be incorporated into practical business operations and then turn into a key corporate growth strategy as firms grow in size. For firms aiming to become multiple national enterprises (MNEs), the golden rule to success is crystal clear.

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Chapter 6

Creating Shared Value in the Context of Sustainability: The Communication Strategy of MNCs

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Additional information is available at the end of the chapter

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Abstract

Creating shared value in the context of sustainability is a way to integrate stakeholders in business management. In addition, companies use a specific communication strategy to communicate the results of sustainable activities involving strategic stakeholders. In a sample of companies included in the Dow Jones Sustainability Index and Global Rep Track 100, we analyze the corporate social responsibility (CSR) strategy of these companies, how they integrate the Sustainable Development Goals, and how they create a dialogue with their stakeholders across different platforms. The study of the sample is performed by content analysis on identity values and their correspondence with the CSR values, and this study includes an analysis of activities that these companies develop communicating their impacts. The results show that companies have actively integrated their stakeholders into their business management. However, these companies incorporate the concept of value creation in a different manner, although their activities are oriented to the stakeholders as to the benefit of society.

Keywords: sustainability, corporate identity, corporate social responsibility, creating shared value, communication, corporate reputation

1. Introduction

This chapter aims to analyze how multinational companies from different countries integrate sustainability and corporate social responsibility (CSR) values in their corporate strategy connected with Sustainable Development Goals (SDGs) [1]. Second, the chapter aims to explore if the sustainable activities of these companies create shared value to the stakeholders and how these companies communicate their impacts and results.

Sustainability is a new paradigm to define the society in the beginning of the twenty-first century. It is based on how companies contribute to improve the society including CSR values and communicating its activities using platforms and different channels. Its objective is to increase their credibility through the commitments with the stakeholders when companies communicate these values in an effective way. As a consequence, companies benefit the society through its sustainable activities.

This analysis is based on case studies with data collected through the corporate webs of MNCs (reports and corporate documents). Companies use different platforms and channels, i.e., social media, to create a dialogue with stakeholders based on sustainable activities analyzed in the chapter through content analysis.

Our proposal is based on the idea that companies create value if (i) they have a clear and measurable sustainable strategy and if (ii) they communicate their impacts and results to involve their stakeholders. As a result, sustainable companies create value to the stakeholders and contribute to social change through its activity.

2. Theoretical background

In order to analyze the social commitment of companies, we consider these aspects developed in the academic literature: identity values and CSR values, and the strategy of companies to create shared value to the stakeholders and benefit the society. Finally, the communication strategy of the impacts generated as a result of their actions. These points are analyzed in the following sections.

2.1. CSR and sustainability

In the beginning of the twenty-first century, there was a debate about the relationship between the companies and its stakeholders [2, 3] and the role of companies in society [4]. In this context and based on sustainability values, companies integrated corporate social responsibility (CSR) [5] in their corporate identity [6, 7] to improve the relationship with its stakeholders. From this perspective, companies have the responsibility and the opportunity to contribute directly to reduce negative impacts and benefit the society if they include environmental and social issues in their business strategy [8]. This means that companies, considering the stakeholders′ expectations, tend to be profitable, legal, and ethical so that they are in a better position to improve the society and create shared value to the stakeholders [9]. In addition, different motivations explain why companies include CSR activities [10] from a multilevel CSR perspective: institutional, organizational, and individual levels [11]. As a result, if companies include sustainable values, they increase the competitiveness, differentiation, and reputation.

Companies use international standards to measure their CSR activities, both in developed and in emerging markets [12]. In addition, global initiatives are taken over by companies in their commitment to sustainability, for example, the Sustainable Development Goals of United Nations [1]. Finally, to evaluate the real contribution to the society, companies assume different commitments and thus measure and communicate their results through different channels.

2.2. CSR communication

Communication represents the need of companies to communicate with stakeholders and create a dialogue using different channels. Thus, it is the opportunity to promote the differentiation from other companies [13]. As a consequence, communication is crucial in the company strategy and a bridge between business and stakeholders [14]. The companies that involve stakeholders through collaboration can increase their credibility and reputation [15, 16]. Communication based on different commitments and activities is the manner to integrate the company values [16, 17]. As a result of this, corporate communication messages contribute to increase the differentiation of the firms. In addition, when companies define and create clear messages using a variety of channels and platforms to explain sustainable activities, companies are perceived as responsible and ethical [18]. From the perspective of communication strategies, some companies have evolved from reactive strategies to proactive strategies of communication [19]. The results may vary depending on the communication process used and the values that companies communicate [20, 21].

To achieve these objectives, companies use the conventional media and, above all, the social media. This provides firms with the opportunity, through bidirectional messages, to communicate by generating content of interest to stakeholders and society [22] in a more transparent space [16]. Therefore, communication acquires a new dimension whose purpose is to overcome the mistrust generated by corporate messages exclusively associated with reinforcing image and that, as a result, are perceived negatively by the stakeholders [14].

3. Sample

To perform the study, we first selected the companies that RobecoSAM identifies as industry group leaders within the Dow Jones Sustainability Index World (24 industry groups). The DJSI World tracks responsible companies based on RobecoSAM Corporate Sustainability Assessment. This consists of an annual evaluation of responsible business practices in companies and considers 80–120 industry-specific questions asked over 3400 listed companies. The questions focus on economic, environmental, and social factors [23]. The companies included in the Dow Jones Sustainability Indexes have been widely used as a framework to analyze CSR and its effects in several fields such as financial performance, reputation, or communication strategies [24–29]. Finally, we eliminated those companies which, as industry leaders within the DJSI World, did not appear on the 2016 Global Reptrak 100, an annual study conducted by Reputation Institute that measures the reputation of the world's most well-regarded and recognized companies from 15 countries. The Reptrak analyzes stakeholder perceptions through seven business dimensions: performance, products/services, innovation, workplace, citizenship, and leadership [30]. The Reptrak has been shown to be a good measure for brand reputation [31], and the companies listed are often used to run a vast range of studies [32–34]. After the selection of these companies, our final sample consists of seven companies from the following industry groups and countries:

1. BMW Group, Automobiles and Components (Germany): The company was founded in 1916 in Munich. BMW has three brands: BMW, Mini, and Rolls-Royce. By developing, manufacturing, and selling automobile vehicles and motorbikes as well as being involving in financial services, BMW and its brands have a clear premium positioning.
2. Nestlé, Food, Beverage and Tobacco (Switzerland): The company was founded in the mid of the eighteenth century. It is a leader in the Nutrition, Health, and Wellness Industry. Nestlé is characterized by its support to innovation, research, and development. The company's research not only focuses on their food and beverage portfolio (over 2000 brands) but also conducts research to help people improve their health. From its "global" strategic approach, Nestlé has gained recognition among worldwide audiences.
3. Philips, Capital Goods (Netherlands): Philips operates the following businesses: personal health, diagnosis, and treatment; connected care; and health informatics and lighting. Philips employs over 105,000 people and operates in 25 countries.
4. HPE, Technology Hardware and Equipment (United States): Hewlett Packard Enterprise was founded in 2015 after the splitting of the HP. It is a business-focused organization that works in servers, storage, software, and financial services. The company aims to increase efficiency among IT environments.
5. LG Electronics, Consumer Durables and Apparel (Republic of Korea): This Korean-based manufacturer employs more than 77,000 people. Its main activity reaches from home entertainment to home appliance. By offering products such as the OLED TV or the sponsorship of Formula 1, LG Electronics has gained a strong positioning. Besides, LG also research to improve energy efficiency.
6. Unilever, Household and Personal Products (Netherlands): The company has more than 400 brands. The company is a leader in the household and personal products industry. The company has increased its market presence, and it currently employs more than 168,000 people.
7. Roche, Pharmaceuticals, Biotechnology and Life Sciences (Switzerland): The company is the world's largest biopharmaceutical company. Roche is a leading company in fields such as *in vitro* diagnostics, oncology, and the personalized healthcare. Roche employs more than 90,000 people, and it has increased sales in major market during 2016.

All these companies have integrated a sustainable strategy that takes into account an Environmental, Social, and Governance (ESG) approach and lead business reputation across multiple markets.

4. Methodology

The research is based on case studies [35]. This approach was chosen because it allows us to identify and explain in-depth features of the research goals: (i) analyze how multinational

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companies from different countries integrate sustainability and CSR values associated with Sustainable Development Goals, (ii) explore whether the sustainable activities create shared value to the stakeholders, and (iii) how these companies communicate in different channels their impacts and results.

In other words, the case study allows us to understand how the most valuable responsible companies (DJSI World) and most reputable companies (Reptrak) are creating value for society and contributing to social change through their CSR approach. Furthermore, we analyzed the sustainability reports and corporate websites of the sample companies to assess how these companies communicate its CSR commitments. The use of corporate documents such as sustainability reports or websites in academia is very widespread [12, 13, 36, 37]. These documents were examined for any information related to the following concepts: (a) corporate identity and the links to CSR strategy, (b) shared value approach, (c) stakeholder dialogue, (d) references to the Sustainable Development Goals, and (e) the presence of CSR information in online communications channels. The aim of describing these items is to understand how reputable and responsible companies outline the concepts that lead the current CSR conversation among academics and practitioners. In short, we analyzed the link between CSR and reputation for companies.

5. Results

We summarize the results of this analysis in **Table 1**. **Table 1** highlights main topics related to corporate identity, CSR strategy, shared value approach, Sustainable Development Goals (SDGs), and online corporate communication channels.

It is relevant to mention that the companies link corporate identity to CSR approach. The whole sample runs sustainability issues by following the framework given in its identity. For instance, while BMW insists on a corporate identity defined as "We shape tomorrow's individual premium mobility," the company focuses on a CSR strategy that leads to ten strategic areas closely related to sustainable mobility, products, production, and employees. The strategy considers the importance of footprint and innovative responsible business. Thus, the Group pursues CSR activities that lead to a *tomorrow's individual premium mobility.*

Besides, companies such as Unilever align corporate identity with its whole CSR strategy. This company asserts that its motto is to *make sustainable living commonplace.* To follow this identity, the company has already set out three big goals: improving health and well-being, reducing environmental impact, and enhancing livelihoods. The three of them pursue a *transformational change* in the corporation's business and affect the CSR perspective.

This kind of approach is related to literature review and enhances that reputable and responsible companies have already understood that corporate identity must define the intangible asset management, especially, when these companies are managing ambitious CSR strategies (**Table 1**).

Company	2016 Global Reptrak rank	Brand identity	CSR strategy	Shared value approach	Stakeholder dialogue	SDG mentions	Online corporate communication channels
BMW	4	We are Number ONE. We inspire people on the move. We shape tomorrow's individual premium mobility.	Ten strategic sustainability goals for 2020. Three main areas: (a) Products and services, (b) Production and value creation, and (c) Employees and society.	Growth leads to increased benefits for capital providers, attractive salaries for employees and, through greater income tax payments, more benefits to society.	To create a comprehensive learning process for the constant development of ideas. Currently dealing with urban mobility challenges.	A framework for solutions to environmental and societal challenges used in strategic meetings.	Four. Facebook, Twitter, YouTube, and Google+. Content. CSR, sponsorships, product development.
Nestlé	22	We are the leading Nutrition, Health and Wellness Company. We enhance lives with science-based nutrition and health solutions for all stages of life, helping consumers care for themselves and their families.	Thirty-nine commitments for 2020. Five main areas: (a) Nutrition, (b) rural development, (c) water, (d) environmental sustainability, (e) our people, human rights, and compliance.	Being a global leader is an opportunity to create long-term positive value for society. Creating Shared Value must be embedded across all parts of the business.	To ensure the company receives independent opinions and feedback. Currently running meetings about value chain and the promotion of its shared value strategy.	SDG2, SDG6, SDG12, and SDG 13 are aligned with its Creating Shared Value strategy.	Eleven. Twitter (corporate and consumer care), Facebook, LinkedIn (Careers and Insights), Flickr, YouTube, Tumblr, Pinterest, and Google+. Content. CSR, corporate Issues and events.
Philips	23	Mission. To improve people's lives through meaningful innovation. Vision. We strive to make the world healthier and more sustainable through innovation.	A new plan called "Healthy people, sustainable plan" (2016–2020). Three main areas: a) sustainable solutions, b) sustainable operations, and c) sustainable supply chain.	Not mentioned.	To participate in meeting and forums to interact with multiple stakeholders. Especially, employees, customers, suppliers, governments, NGOs and Investors.	SDG2 and SDG12 are some of the most important because of their link to the CSR strategy.	Five. Pinterest, Twitter, Facebook, Google+ and Facebook. Content. CSR and corporate issues.

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Company	2016 Global Reptrak rank	Brand identity	CSR strategy	Shared value approach	Stakeholder dialogue	SDG mentions	Online corporate communication channels
HPE	36	We are in the accelerations business. We help customers use technology to slash the time it takes to turn ideas into value. In turn, they transform industries, markets and lives.	The Living Progress framework integrates environmental, human and economic sustainability through three themes: a) accelerating efficiency, b) accelerating fairness, c) accelerating opportunities.	IT has the power to change the world by solving social and environmental challenges.	To understand external priorities, share expectations of conduct and performance, learn and innovate, contribute to industry-leading initiatives and hold the company accountable to the highest standards.	Not mentioned.	Six. LinkedIn, Twitter, YouTube. Also, a CSR Twitter account and the HPE Community (multi-thematic forum with blogs about different topics). Content. Corporate, products, innovation. HPE hold a specific CSR Twitter account. The HPE Community also manages a blog called 'Inspiring progress' in which they talk about CSR.
LG	61	Vision. Jeong-do management. To become the market leading company with broad market recognition. Conduct. LG will succeed through the constant development of capability based in ethical management.	The goal is to take care of its communities, help those in need to become self-reliant, and interface, communicate and form a trust based relationship with stakeholders. To achieve this, LGE has four themes: (a) CSR change management, (b) CSR risk management, (c) stakeholder engagement, (d) strategic social contribution.	LGE builds up fundamentals through constant innovation to serve customers with earnest sincerity and deliver a greater value. LGE also ensures fairness in opportunities for advancement and compensates employees fairly based on merit and performance.	To address the concerns and meet the expectations of its stakeholders by delivering differentiated value.	SDG3, SDG7, SDG8, SDG11 and SDG12 are the signaled as first priority. SDE4, SDG6, SDG9, SDG13, and SDG16 belong to second priority.	Three. LG Jeong-do management ethics hotline, Questionnaire, YouTube. LGE also manages a product-perspective social media accounts. Content. Retrieving feedback and corporate issues (YouTube.)

Company	2016 Global Reptrak rank	Brand identity	CSR strategy	Shared value approach	Stakeholder dialogue	SDG mentions	Online corporate communication channels
Unilever	89	To make sustainable living commonplace.	Unilever Sustainable Living Plan sets out three big goals: (a) Improving health and well-being, (b) reducing environmental impact, and (c) enhancing livelihoods.	Creating "transformational change" to whole systems, not simply incremental improvement, to make a difference in those big issues that matter most to Unilever's business and to the world.	To inform its decision-making, strengthens its relationships, and help them deliver its commitments and succeed as a business.	SDG2, SDG5, and SDG5 are some of the SDG mentioned as well as the aim to eliminate deforestation and mainstreaming sustainable agriculture. Unilever also manages "the collective action," a campaign to change the way business is done.	Seven. A web page that includes "topics of interest for its visitors." Also, a web page called "Join In," a section that brings together different topics and the #collectiveaction hashtag. Surveys and Facebook, Twitter, YouTube, and LinkedIn. Content. The Facebook page landed in country of the users. The rest of channels are quite focused on CSR and the #collectiveaction initiative.
Roche	90	Doing now what patients need next	Roche seeks to deliver sustainable business growth and value by five areas: (a) sustainable healthcare, (b) responsible business, (c) employees, (d) energy and the environment, and (e) community support.	To create value through developing medical solutions, and Roche aims for as many people to benefit from them as possible (specifically, patients, employees, partners, environmental, and communities).	To earn the trust of Roche's stakeholders and understand their concerns.	Roche focuses on SDG3. The company also links sustainable strategy areas with SGDs.	Six. Twitter, LinkedIn, Facebook, YouTube, and Pinterest. Content. The company talks not only about corporate issues but also about CSR topics. Facebook is more related to careers rather than corporate issues.

Table 1. Key findings.

5.1. Shared value approach

The Porter's Creating Shared Value seems to be misunderstood among sample. Especially because these companies make no distinction between shared value and "create value." While Nestlé rightly underlines that "being a global leader brings not only a duty to operate responsibly, but also an opportunity to create long-term positive value for society," other companies underscore that creating value refers to the redistribution of wealth among stakeholders by increasing profitable growth or providing the products or services companies offer. Thus, in these cases, the value creation involves a sort of indirect effects on stakeholders (derived from the business itself) but does not demand any kind of specific effort within the company. Nevertheless, companies such as Nestlé and Unilever have implemented some strategies that are aligned with the concept:

- Nestlé has turned the concept of shared value into a "mantra." Partly because the seminal Porter's paper not only referred to the company as a good example of his proposal but also due to fact that every single aspect of the company's intangible asset strategy supports the idea of creating long-term value for society, Nestlé carries out multiple initiatives to promote and increase wealth among communities. The company states the Creating Shared Value strategy involves commitments in some areas: (a) nutrition, (b) water, and (c) rural development. The company encourages consumers to understand the effects on health of a well-balanced nutrition (i.e., by promoting education on the importance of nutrition from conception to the child's second birthday over 5 million mothers and caregivers worldwide), endorses initiatives to improve access to water across its value chain (i.e., in 2015, 440,000 people have already gained access to water, sanitation, and hygiene among its stakeholders), and also supports rural development where company's supply chain farms are located (i.e., 400,000 farmers have been trained through capacity building plans).
- Unilever asserts focusing on big issues that matter to the world and its own business. The company seeks a transformational change whose definition is clearly close to shared value. Unilever claims that deforestation, sustainable agriculture, and universal access to drinking water, sanitation, and hygiene are global issues. The corporation works together with governments, NGOs, and partners to fight against these problems and improve worldwide communities and smallholder farmers.

However, most of the sample endorses "creation of value" by offering products or services that improve societies but undervalues the accurate meaning of shared value. Thus, some of these companies deploy ambitious CSR initiatives, but there is no link to the concept of shared value. Despite the fact that these companies are leaders in CSR, the shared-value perspective is not part of their corporate narrative, especially, because they do not encourage the original meaning of "Creating Shared Value" that involves a commitment with stakeholders to improve the relationship with each of them as well as to benefit the society.

5.2. Endorsing stakeholder dialogue

The sample shows a very particular interest in stakeholder relationships. The companies underscore the importance of having a frequent and transparent link to different audiences.

The opportunity to get *independent opinions and feedback*, *learn from stakeholders*, *evaluate the ethical and environmental issues*, *contribute to industry-leading initiatives*, and *earn the trust of audiences* are some of the reasons why companies are running stakeholder dialogue across multiple markets.

Beyond improving CSR strategies and ethical commitments, the stakeholder relationships are focused on increasing business efficiency and facing the competition with a very well-designed business approach based on audiences' feedback. Although this might seem far from the CSR perspective, the truth is that companies also dialogue about ethics and intangible assets to obtain a holistic frame of stakeholder's expectations.

The common approach to mapping stakeholder relationship involves the following process: the companies first prioritize groups by following internal decisions and analyzing opportunities and risks. Then, the corporations set up a communication plan and define stakeholder's goals. Once they have established the goals and communications procedures, the companies monitor needs and manage the communications goals.

These corporations usually establish specific communication channels to disseminate corporate information and gain feedback. It is common to outline the following media: regular meetings, surveys, webinars, joint projects, consumer panels, working groups, research projects, and road shows.

In addition to this constant process, the sample asserts that it is common to run specific forums to deal with complex topics or major issues:

- BMW runs two different formats: BMW group dialogue (with expert and leaders form different industries) and BMW group student forums. Both try to identify opportunities, manage and shape reputation, and reduce risk. The group is currently dealing with urban mobility challenges. This kind of perspective allows the company to not only improve its business strategy but also integrate sustainable approaches so the relationship with CSR is close enough.
- LG Electronics started a semiannual stakeholder consultation from 2010. This is an internal panel, presided by an independent expert in CSR who leads dialogue about environment, product safety, accessibility, and disabilities.
- The Unilever Sustainable Living Lab attracts people form governments, NGOs, and business to discuss online about sustainable issues. Over 15,000 registrants from 77 countries have participated and more than 4000 comments have been shared.
- Roche's website provides KPIS to stakeholder so that they can monitor progress in relevant CSR areas. The company fosters transparency by updating the status of these KPIS in a simple way. Roche builds up the KPIs by running annual sustainability forums with patient organizations, government officials, customers, health care professionals, the scientific community, etc.
- Nestlé promotes stakeholder dialogue by organizing events. The main topics of these meetings are related to value chain issues and the way to improve and foster its Creating Shared

Value strategy. In 2015, the company organized two stakeholder meetings. The 2015 Nestlé sustainability Report also announced the Biennial Creating Shared Value Global Forum, which was going to be held in 2016 to discuss about "Investing in Sustainable Development in Africa."

- Philips annual report expresses that the company "engage with, listen to and learn from" stakeholders. The company does not provide specific information about the process. Nevertheless, Philips annual report underlines activities by stakeholder (i.e., the company runs regular meetings, surveys, and webinars among employees; establishes joint projects, consumer panels, Net Promoter Score (NPS), and customer care centers with clients; and also organizes supplier forums, working groups, and training sessions).
- HPE asserts that everything they "do is built on partnership with customers, employees, leaders, suppliers, policy makers, industry bodies, nonprofits, and sector experts." The company does not explain the way it maps and engages stakeholders, but HPE lets readers know that it shares updates on its progress on Twitter and a blog. Since 2014, the company runs "Living Progress Exchange." This is a biannual online session where creative and sustainability leaders form several industries and discuss about technological progress.

5.3. Promoting Sustainable Development Goals

The analysis shows that SDGs has been adopted by sample. In only one and half year, some of the most reputable companies have started implementing coherent discourses about SDGs. **Table 2** describes the relationship between SDGs and companies. The information has been noted by analyzing specific mentions within both sustainability reports and websites:

The SDGs business agenda 2030 has specifically focused on "Good health and well-being" (SDG3) as well as "Responsible consumption and production" (SDG12). These are some of the main topics in companies such as Nestlé, Philips, LGE, and Roche. These corporations are carrying out worldwide initiatives to increase life expectancy and reduce common killers associated with child and maternal mortality. We can find some examples of its commitments:

- Philips endorses SDG3 by supporting awareness and access to breast cancer screening in Brazil. In partnership with Brazilian entities, the company has conducted more than 12,000 free mammograms in several communities. Philips has also provided clinical training to over 1200 healthcare practitioners across Africa. The aim is to reduce child mortality rates and increase maternal health.
- The sample also shows interest in SDG12. For instance, Roche has developed the eco-balance metrics. This rate is included in its Safety, Security, Health, and Environment Commitment (SHE). The company aims to a progressive reduction in its ecological impact. The company obtains a view of the consumption of resources such as water and energy, the waste and emissions, and water and oil. Roche relates these variables to the total number of employees so the company is monitoring constantly. By implementing eco-balance ratio, the company has reduced 9.2% of its global ecological impact since 2015. The stakeholders may consult SHE's KPIs in Roche's website.

Sustainable Development Goals	Companies' sample
SDG1. No poverty	
SDG2. Zero hunger	Nestlé, Unilever
SDG3. Good health and well-being	Nestlé, Philips, LG Electronics, Roche
SDG4. Quality education	Roche
SDG5. Gender equality	Unilever, Roche
SDG6. Clear water and sanitation	Nestlé, Unilever, Roche
SDG7. Affordable and clean energy	LG Electronics, Roche
SDG8. Decent work and economic growth	LG Electronics, Roche
SDG9. Industry, innovation, and infrastructure	Roche
SDG10. Reduced inequalities	
SDG11. Sustainable cities and communities	LG Electronics
SDG12. Responsible consumption and production	Nestlé, Philips, LG Electronics, Roche
SDG13. Climate action	Nestlé, Roche
SDG14. Life below water	
SDG15. Life on land	Unilever
SDG16. Peace, justice, and strong institutions	Roche
SDG17. Partnerships for the goals	Roche

Table 2. SDGs implementation.

Despite the interest in SDG, the information given provides a lack of clarity. The sample holds and endorses a responsible positioning on SDGs. However, the reporting is not clear. The companies support the goals and underline the main objectives, but the sample has tried to link preexisting initiatives to current UN Goals. The reporting thus is confusing because stakeholders are not able to conclude whether SDGs have been endorsed or simply adjusted. It would be a good idea to provide a final index (such as companies do with GRI) in which readers could find specific content related to every SDG. Furthermore, the analysis has shown that the SDGs' Goals are closely related to business and CSR strategy. It may be better to display a complete SDG status to explain why and why not they partly handle the goals.

5.4. Online CSR dissemination

The sample provides corporate information in social media and owned media (websites, corporate blogs, and press releases). Most of the CSR issues are disseminated by traditional channels such as web pages or sustainability reports, but they also use social networks (see **Table 1**). Nevertheless, some companies have developed new ways to communicate its commitments or receive feedback.

- LG Electronics carries out two initiatives to understand stakeholder expectations: Questionnaires and the Ethics Hotline. By following LG Jeong-do management, the company provides access to a questionnaire. LGE asks respondents: *Which level do you agree upon the status of LGE? (a) Does not care laws for economic profit, (b) Does not care for ethical/CSR agenda, only focused on compliance, (c) Only focused on social contribution or response to stakeholder's pressure, (d) CSR activities performed systematically throughout value chain, based on the belief that CSR helps improve corporate reputation and competitive advantage, (e) CSR is considered as the key philosophy of the company and lead to market creation and definition of new business rule.* And the survey also checks perceptions about website clarity, areas of interest, and qualitative questions related to major CSR concerns. All this information crosses the stakeholder. Besides, the company gets access to an Ethics Hotline to report unethical or illegal behavior.
- Unilever is clearly interested in disseminating information about the CSR. Beyond corporate social networks, the company has set up multiple initiatives to spread its "Transformational Change." Under the hashtag #collectiveaction, the company endorses multiple activities to transform its business. The readers can find information and interviews to different entrepreneurs about the way they are implementing SDGs. There are many posts about sustainable businesses or the benefits of sustainability. The corporate social networks hold the hashtag #collectiveaction and provide constant information about the CSR within the company or the partners.

In short, the companies have added the CSR discourse to its communication channels. Some of the companies share both corporate information and CSR. However, some corporations have set up specific channels to promote or receive CSR feedback among stakeholders. It is not clear which is the best strategy. While the use of corporate channels might be appropriate to show CSR as a clear commitment within the business, the use of CSR-oriented social networks may allow companies to increase CSR awareness and gain valuable information about stakeholder's expectations.

6. Discussion and conclusion

The companies selected for the sample have integrated sustainable values into their corporate strategy and are leaders in the field of CSR and reputation. These companies are included in the Dow Jones Sustainability Index and in the Global Reptrack 100 ranking. One way to assess their sustainable commitments is their involvement with the Sustainable Development Goals, which the sample companies have integrated into their CSR strategy giving priority to different goals. In addition, these companies communicate the results of their activities related to sustainability through different reports on their websites to create value to their stakeholders.

Furthermore, these companies have created profiles in different social media where they generate a dialogue with their stakeholders through the different corporate activities they develop, including activities based on their CSR policies.

As a consequence, these companies create shared value through sustainable programs and activities that benefit society as a whole. This implies that companies take into account the expectations of their stakeholders in its strategy by integrating a significant number of activities and its impacts. Then, these companies connect their CSR values with identity and translate it into actions that enhance its corporate reputation.

Companies use different channels to generate a dialogue with stakeholders (Facebook, Twitter, YouTube, etc.) in relation to different interests of companies. However, these leading companies in sustainability can increase engagement with its stakeholders through a dialogue that serves to involve them in the sustainable development. From this perspective, SDGs represent an opportunity to provide dialogue and involvement with stakeholders based on actions that directly improve society in specific areas.

Although we find similar behavior in these companies, since they include CSR in their business model, each of them has a differentiating strategy that they communicate using some messages in different channels.

In this sense, the concept of creating shared value is a way of understanding the value proposition that only some of these companies integrate into their strategy. However, these corporations give relevance to their stakeholders, so they can create a more extensive dialogue based on its sustainable proposals (SDG). Thus, these companies succeed in promoting the benefit to society from its CSR strategy by involving its stakeholders in its development and, thus, leading social change. From this perspective, companies have the opportunity to use their social media as platforms to transform society in a real and measurable way.

Finally, future research can provide new uses of business communication based on the transformation of the society as long as companies use methods to measure their impacts. The consequence is that companies can gain credibility based on results where they explain how they create shared value from different business areas.

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Chapter 7

Strategic Corporate Performance Management: A Customer-Oriented Approach

Lilia Dvořáková and Olga Faltejsková

Additional information is available at the end of the chapter

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Abstract

The contemporary world is characterized by enormous development of globalization on the basis of fast spread of information enabled by modern information technologies. The development of the last decades is very difficult to predict. Under these conditions, the society's paradigm is changing as for the corporate economy management. The significance of non-financial indicators grows, they, in connection with the financial ones, can identify conditions much better and influence corporate performance indicators. An important role is played by the interdisciplinary holistic approach to corporate management, responding to rapid changes in production related to the individualization of the products according to customer requirements and shortening its life cycle. Under these conditions, the most important factor for market success becomes a customer, whose satisfaction and loyalty to the company must be measured to be able to create conditions for stable growth corporate performance. The great attention is also given to the theoretical basis on which corporate performance management is created. The most important part of customer-oriented management is data acquisition from the measurement of customer experience. The questionnaire survey was the basis for gaining of the primary data source for the customer's satisfaction and loyalty measurements on the net promoter score (NPS) principle.

Keywords: customer satisfaction, net promoter score, performance, strategic management

1. Introduction

P. F. Drucker:

'*The customer is the foundation of a business and keeps it in existence. He alone gives employment*' [1].

The beginning of the twenty-first century is characterized by unprecedented growth in globalization due to the rapid distribution of information, made possible by modern information technologies. Numerous spheres of human activity shift in relation to the development of new technologies, the dawn of new economics and the growth of competition due to rapid fluctuations in the cycles of boom and crisis. In recent decades, development has gradually changed from a curved or spiral path into the reverse, the unexpected and almost unpredictable. According to Drucker: '*There is only one certainty: the future will be different from what we have today*' [1].

Turbulence, chaos and discontinuity, as manifestations of the current global world, bring new views on the measurement and management of corporate performance. Current conditions place more importance on non-financial indicators, which, in connection with financial indicators, can better identify the conditions influencing changes in the parameters of corporate performance. The new direction of corporate management, oriented towards performance, is associated with the transition from static models to dynamic models, which react flexibly to changes in the business environment. A holistic interdisciplinary approach to corporate management plays a significant role in this process.

The introduction of new technologies enabling rapid production growth and a decrease in the price of products and services easily increases the excess of offer over demand. This increases pressure on competition, resulting in a battle over markets and new customers. Besides cost and quality, time becomes an important factor in this competition. The global economic environment, as we have known it over the last decade, has led to the individualization of industrial products in order to correspond to customer wishes and, at the same time, to a shortening of the life cycle. Such products also include automobiles.

Changes in the requirements for industrial products are related to the transition from classic large-scale production, producing standardized products to new production conditions of value for the customer, able to adapt to customer demands and individual needs. In the surroundings of global competition, it is very important for a company to measure customer satisfaction in order for the conditions for stable production growth to be created. Under these changes, corporate management style and management skills must also change.

2. Theoretical background

2.1. Corporate performance in the twenty-first century

In the current global world, performance can be perceived as the success rate of a company on the market, the ability to succeed in competition and to find opportunities for further growth in the changing, unstable economic environment of the global world. The success rate is that which can be seen under the term performance under current conditions. Drucker states, '*If you can´t measure it, you can´t manage it*' [1].

But if we measure, we must first know what to measure and how to measure it. Net present value (NPV) is a suitable scale for measuring company's performance from the investment

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point of view because it also takes risk and time factors into consideration. In the last 10 years, the focus has mainly been on the economic value-added (EVA) indicator; there is a connection between NPV and EVA, as proved by Richtárová [2].

EVA can be understood as a system of company management enabling not only performance measurement, but also the evaluation of investment projects, companies and acquisitions, as well as management salaries. EVA is one of a new generation of financial indicators, of the so-called lead character, that will 'turn on the red light' in time. Classic financial indicators are unable to respond in time to the changing, chaotic and turbulent environment of the globalized world. Despite the indisputable advantages, there is a problem with the adjustment of input data for the calculation of an indicator, even if the capital is defined as the source for financing the activities producing operative turnover [3].

2.2. Performance architecture and strategic management

Performance measurements at a higher, more evolved level of performance-oriented company management represent complex approaches, enabling the connection of non-financial, explicitly acting indicators with performance growth financial indicators. Well-known management systems include the balanced scorecard (BSC). Its basic goal is the balanced satisfaction of company shareholders [4]. Because of the heterogeneity of its requirements, it is important to agree on a mutual corporate goal which, even from a futuristic point of view, means performance. The BSC system enables the connection of financial indicators with non-financial indicators and distinguishes the lead (moving, future predicting) indicators and the lag indicators, expressing the consequences of acts and processes. Relying only on financial indicators can significantly limit future corporate potential [3]. A subject analysis of performance can be supported by a causal map enabling not only recognition of causes and consequences, but also complications of these relationships within the company [5].

The new direction of the twenty-first-century company management, oriented towards performance, is associated with the transition from static models to dynamic models, which react flexibly to changes in the business environment. Controlling becomes an important part of these systems for its integration potential. From this point of view, Horváth's 'architecture of performance' can be introduced [5], as shown in **Figure 1**, connecting controlling, balanced scorecard and company processes (with the use of activity-based costing) into a joint system of strategic corporate performance management.

Havlíček [6], an expert in the field of company management, also takes note of the potential of controlling and its integration abilities. So, complements the traditional sequential model of strategic management, which includes strategic analysis, strategy formulation and strategy implementation of the fourth stage, which is strategic controlling (**Figure 1**). He introduces controlling from the point of view of process management, which, if needed, connects other disciplines of corporate management and thus becomes a multidisciplinary system.

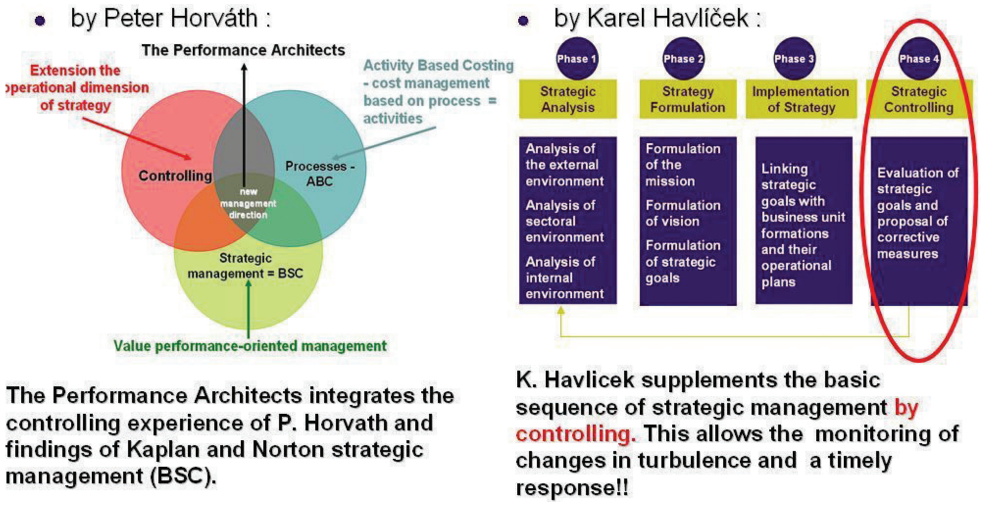

Figure 1. Management as the Horváth's multi-criteria tool in comparison with process approach by Havlíček. *Source:* Authors' own adaptation, according to Horváth and Partners [5] and Havlíček [6].

This concept of corporate management, able to respond quickly to changes in macro and micro company environments, does not renounce data taken from accounts, because this is considered a source of lessons learnt in the past.

The concept of 'performance architecture' emphasizes the orientation towards value for the customer from a strategic point of view by interconnecting BSC with other concepts or management tools such as activity-based management and EFQM (European Foundation for Quality Management) excellence model. The connection with benchmarking, enabling comparison with competitors in related fields, is especially important.

From the preview, Czech authors Keřkovský and Vykypěl [7] suggest that strategic management should be seen as a never-ending process, a sequence of repeated and successive steps, beginning with defining the company's mission and its objectives and strategic analysis and ending with the formulation of possible solutions (strategies), selection and implementation of optimal strategies and the control and correction during their implementation.

Under these circumstances, the strategic direction is of greater importance than the documents themselves, which creates (strategies and strategic plans), as they may be at the time of its creation date. Management processes allow a greater role in continuous evaluation and flexible decision-making on the selected development trend (**Figure 2**) as follows:

- Operational controlling is able to integrate all management systems, based on regularly recurring cycles.
- The monitoring, forecasting and analysis of deviations allow the detection of changes in the development of turning points, which involve capturing strategic gaps and timely response.

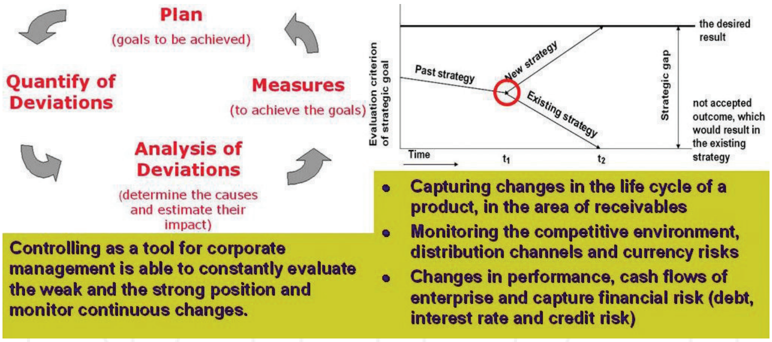

Figure 2. Cycle of operational controlling and monitoring of changes. *Source*: Authors' own adaptation [8].

The Kaplan and Norton's integrated systems of indicators, allowing connection of financial and non-financial indicators, are also balanced scorecard (BSC). For application of the BSC into corporate practice, it is very important that managers identify activities affecting corporate performance and set the required indicators (**Figure 3**). By combining strategic management and controlling, a company gets an opportunity to respond adequately and timely to the variability of macroeconomic and sectorial corporate environment. The standing of controlling in current conditions is evidenced by the numerous investigations, which prove the fact that companies with well-functioning controlling more easily overcome the crisis.

The new trend is the indicator of 'economic value-added' (EVA) that directly reflects the risk in calculating the structure and corresponds better to the requirements of strategic and performance-oriented corporate management.

Integrated methods of management combining elements of controlling, procedural and strategic management, as more precise measurement of company performance and gives a much more complete formulation of objectives for all levels of corporate management.

2.3. Customer orientation

Who is the customer and who is the consumer? Consumer is much more general term, as they consume the product regardless of whether they bought it or not. The customer is the person who ordered the product and paid for it.

In this context, the term 'consumer behaviour' can be clarified. In general, according to Vysekalová [10], consumer behaviour is focused on satisfying certain needs. These, however, cannot be perceived in isolation, because the consumer makes decisions based on many factors—cultural, economic, psychological, social, etc. These also influence the final result of consumer behaviour.

The model of the Black Box in **Figure 4** shows the complexity of the prediction of the behaviour of a person in the role of consumer and customer, even though there is a whole range

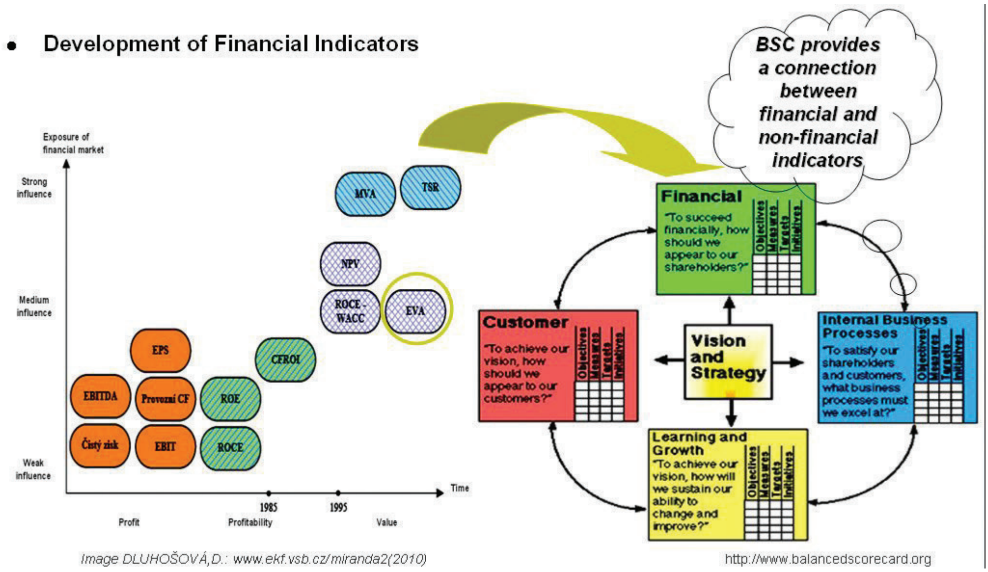

Figure 3. Connection of financial and non-financial indicators as a new trend of strategic management. *Source*: Authors' own adaptation [8], using image [9] and www.balancedscorecard.org.

of new knowledge brought about by modern science. The Black Box is perceived to be the human mind, as it is very difficult to infer what happens inside. Exogenous variables can be researched, quantified and some of them even influenced, or finished. So, it is possible to look into the Black Box and deduce the influences affecting consumer purchase behaviour.

According to Kotler and Armstrong [11], during a purchase, the consumer experiences a decision-making process with numerous phases such as problem recognition, information search,

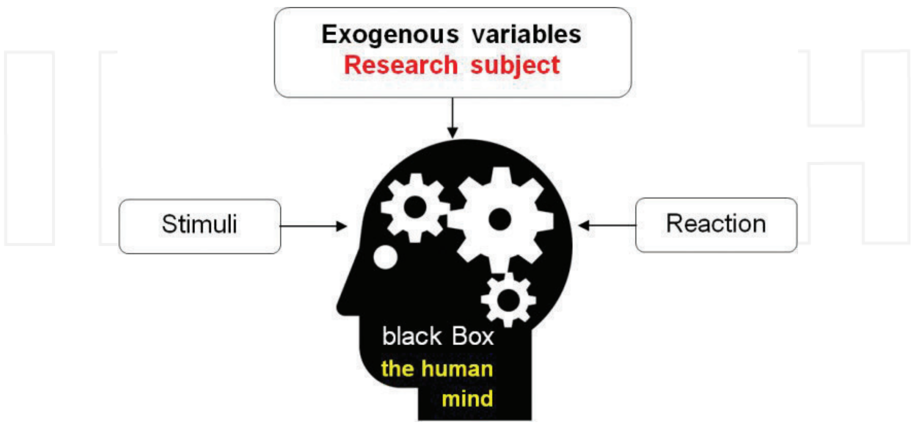

Figure 4. Black Box model (stimulus and response). *Source*: Authors' own adaptation, according to Ref. [10].

evaluation of alternatives and the final decision to actually buy. During the final stage of this decision-making process, that is, after the purchase, the consumer acts depending upon their satisfaction with the purchase. What attracts the consumer (customer) to the product and what influences their satisfaction?

The relationship between the customer and the product can be expressed by the 'philosophy of product layers' of the Dutch scientist Leeflang. The core of the product is represented by its utility value, the extended product is its perceived satisfaction value and the total product represents the extension of product services related to its use [12]. This approach was used to solve research into the creation of a proposed corporate performance management model. Suchánek and Králová [13] researched three groups of attributes influencing performance in total: customer purchase behaviour, satisfaction with the product and the quality of the product. If company profit is linked to price and product quality with production costs, this means that the product and its quality are the link between company performance and customer satisfaction, and the connection to financial performance can be expressed as a model.

The requirements for the growth of customer value create the need to manage customer satisfaction. Kislingerová et al. state that '*Customer satisfaction can be defined as a customer's subjective evaluation of the degree of fulfilment of his expectations about the consumption of a product or service'* [14]. The subjectivity of the perception associated with satisfaction, however, differs from the reality and is enhanced by the level of expectation. Kislingerová et al. also found out that the management of customer satisfaction lies in the identification of key influencing attributes. Influencing these attributes through a number of activities, including quality improvement projects, leads to changes in customer expectations and perception and forms their satisfaction. The improvement of customer satisfaction must be perceived as an investment. '*Customer satisfaction is a mediator in the relationship of cause and effect, when marketing strategies and activities, i.e. money, remain at the beginning and influence the attributes forming satisfaction, loyalty and customer behaviour, i.e. financial flows of society'* [14].

2.4. Relationship of customer satisfaction and loyalty to strategic corporate performance

A long-term partnership with the customer requires the constant recognition of customer needs, motivations and habits and using this knowledge in an innovative process of company offers. Lošťáková et al. [15] characterize the management of customer relationships as an interactive process aimed at achieving the optimal balance between company investment and the satisfaction of customer needs. The optimum balance is specified as maximum turnover at the point of creating a relationship between the company and the customer.

Orientation towards the customer is a holistic approach to marketing, integrated into modern multi-criteria systems of company performance management. Interpreting the term 'custome value', which is perceived very broadly, Tomek and Vávrová [12] came to the conclusion that the terms 'value of the customer' and 'value for the customer' are indivisible. '*Value of the customer in terms of Customer Equity can be analogically perceived as an addition to the value of the company, similarly to Brand Equity. It can be evaluated as an achieved contribution to the payment, and qualitatively as loyalty*'. At the same time, they emphasize that the aspect of permanence plays great role in both value of the customer and value for the customer. '*Continuous relationships with the customer strive for mutual growth of value*'.

To distinguish the most valuable customers, the manufacturer must perform customer segmentation through stratification according to contribution and relationship profitability. Therefore, classification by customer relationship frequency (purchase volume) and contribution (profitability) is monitored. For the company, the matter of customer value has qualitative and quantitative aspects, mainly in relation to the maintenance of long-term strategic performance. Also, the level of satisfaction itself can be used for customer segmentation. Customers differ not only in the level of satisfaction, but also in attributes that create satisfaction. If companies perceive the customer satisfaction as their main goal, they must work with segmentation effectively.

The creator of the net promoter score (NPS), Reichheld [16], moves the issue further when, based on his own research, he states that companies achieving high levels of NPS recorded long-term performance growth. The conclusion is that satisfied, loyal customers are those who bring the greatest benefits for the company from the long-term point of view. The fundamental concept that increases company performance is to satisfy the customer. Comparison with the competition on the principles of benchmarking is an important prerequisite for successful company performance management. It is important to know the position of the company in the relation to performance.

The customer-product-performance relationship is essential for the creation of a proposed corporate performance management model. If the price of the product represents revenue, and quality denotes cost, then these variables can also represent the connection between company performance and customer satisfaction. So, the connection to indicators of financial performance can be expressed as a model, as shown in **Figure 5**.

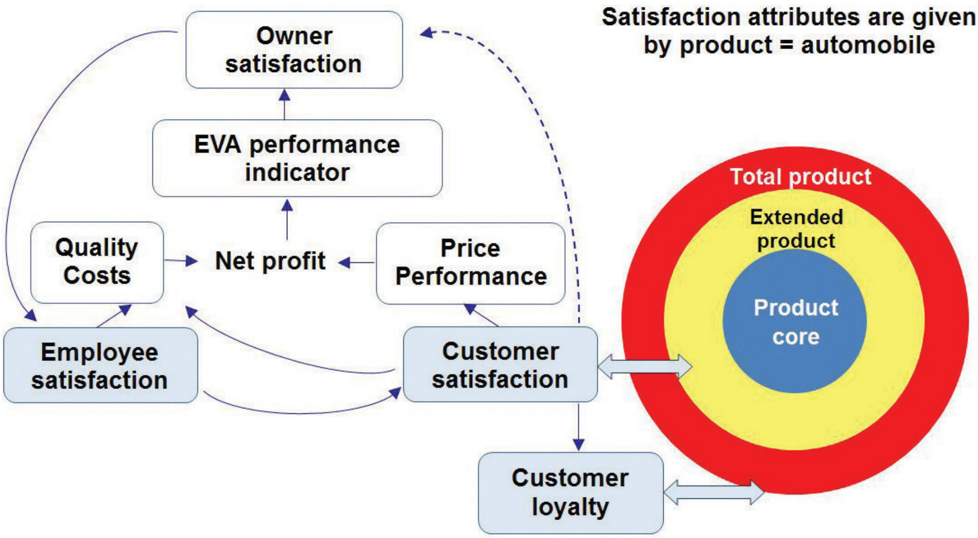

Figure 5. Connections of the simulation performance model based on EVA. *Source:* Authors' own adaptation, with the use [17].

Research into customer purchase behaviour is attempting to reveal the 'Black Box' of consumer decision-making, consumer satisfaction and brand loyalty. In some fields, the data could be confronted with previously published findings. The design of the research is therefore created and completed with findings from scientific articles, market research and other information published on related topics such as specialized and scientific magazines and literature.

In today's global world, customer satisfaction is an important factor ensuring the stability of company revenue, as well as company performance growth. Customers are connected with other interest groups inside the company, employees and owners. By influencing each other, all three interest groups create the preconditions for strategic corporate performance growth, mainly credibility and corporate culture. '*Customer satisfaction is one of the intensive development sources necessary for the creation and strengthening of the competitive position of a company on the market. Satisfaction can be defined as a man's subjective feelings on the fulfilment of his expectations. These are subject to both experience and information, as well as personality and environment*' [18].

Customer satisfaction is most often measured by using different modifications of the customer satisfaction index (CSI), which is based on a barometer of customer satisfaction which has been applied in Sweden since 1989 [19]. It is important to note that the indices of customer satisfaction (ECSI——European customer satisfaction index, ACSI——American customer satisfaction index, CSI) measure cumulated satisfaction, summarizing experiences of customer behaviour, including changes in attitude in the relationship with the supplier.

The net promoter score (NPS) is a method of principles of instant customer experience. The NPS® (net promoter score) was developed by Satmetrix, Bain & Company, together with Fred Reichheld. The first findings on NPS were published in the *Harvard Business Review* [16]. The NPS principle is demonstrated in **Figure 6**.

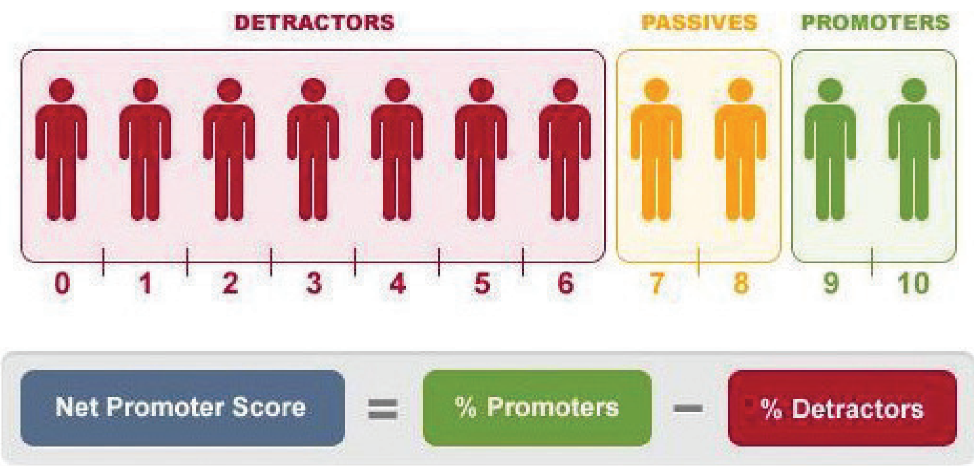

Figure 6. Construction of the net promoter score. *Source:* Van Dessel [20].

The Net Promoter® concept is protected by copyright. A whole range of variants of these metrics and systems was created, mainly in the USA. The NPS concept has gradually become accepted throughout the world and is now also beginning to be accepted in the Czech Republic. Net promoter score (NPS) metrics create a precondition for the observation of customer value, that is, segmentation according to satisfaction. Working with customer segmentation is its greatest significance.

Experience shows that NPS is extremely useful for internal benchmarking; for example, the evaluation of vendors for trade and services companies, including car dealers, but also in the manufacture of products for one specific brand, which is particularly valid in the automotive industry. Organizations achieving high NPS values display the great importance of customer and employee loyalty for business success, as stated by Owen and Brooks [21]. Neumaierová and Neumaier [17] also discovered that NPS as the only indicator does not put customer and company employee into opposition. The metrics have an especially positive influence on corporate culture and the creation of a trusting atmosphere in the customer-employee relationship, creating conditions for sharing tacit knowledge. NPS metrics can also be used for research into B2B relationship satisfaction.

3. Corporate performance customer-oriented as a precondition for strategic growth

Instability and unpredictability of the globalized business environment affect to approach of enterprise to processing and formulating strategy. The basic requirement for companies is flexibility and readiness to environmental changes. The motivation for company management and employees is the question of ensuring the continued existence of the company in the long term.

A basic requirement of managers must be the ability to recognize and respond quickly to change. Global interconnectedness, the rate and intensity of change, speed and strength of the crisis respective spreading throughout the world, should not lead the belief that strategy has become useless under these conditions. On the contrary, it appears that most failures are due to lack of strategic management.

Timeless factors of strategic management can be summarized in three basic areas as follows:

- *be successful*—compare regularly with the competition on the principles of benchmarking,
- *satisfied and loyal customers are fundamental to success and creating value for a company*—regular analysis of expectations of stakeholders, including measurement of customer satisfaction,
- *follow main direction of competitive* fight and specify the direction of company's strategic development.

It is, as is strategic management, focused on the future. Strategic controlling is able to focus on the near and long-term future and uses its tools to track changes, crucial for a new strategy.

4. Findings of customer satisfaction and loyalty research in area of automotive

4.1. Characteristics of the automotive industry from the perspective of Czech Republic

The automotive industry is one of the world's most developed industries. Under the influence of changes over the last decade, mainly in context of the current global economic crisis, it has on the one hand brought about a high level of individualization, corresponding to the needs and wishes of the customer, but with the emphasis on quality and increases in production efficiency by cost saving on the other. Pollution from road traffic also sets limits for production development; ways to replace and overcome these limits are being sought. All this is in conflict with industry economic performance parameters.

Automotive production in the Czech Republic has specific circumstances. It has a long tradition, including qualified and cheap labour. From a global point of view, Czech automotive production is in 13th place, and in terms of the number of automobiles produced per thousand inhabitants, shares first place with Slovakia [22].

It is, therefore, logical that the automotive industry has become the backbone of the Czech economy. The consequence, however, is greater vulnerability in the current subsiding global economic crisis. From the perspective of the small open economy of the Czech Republic, it is apparent that automobile production is mainly intended for export. Other specifics of the market in the Czech Republic include a relatively high frequency of used cars, and their age, which was approximately 14.5 years in 2014 [23].

Dealers are customers of the automotive manufacturers in the B2B relationship. To sell automobiles to the final consumer, the manufacturer uses a distribution network of brand vendors outside its organization structure who also enable sales cost optimization. However, the manufacturer lacks a relationship with the final consumer on the B2C basis, which can create obstacles for management, regarding the value for the customer. Therefore, building a trust-based relationship built on identifying the image of the product, in this case an automobile, with the brand, plays an important role.

The term original equipment manufacturer (OEM) can be found in the automotive industry. It is used for manufacturers of products (automobiles) assembled from parts produced by different manufacturers. In the Czech Republic, the carmaker TPCA in Kolín, who uses the same chassis to assemble automobiles in the business-class mini for Toyota, Citroën and Peugeot, which compete with each other on the car market, can be included in this production method. Moreover, the production of Hyundai cars in Nošovice in the Czech Republic can be termed as OEM. Škoda Auto Inc., in Mladá Boleslav is the only fully fledged automobile manufacturer in the Czech Republic. It is a company with a great tradition of its own research and development centre, engine production, and providing staff education at its own training facility.

The whole chain of the supplier-customer relationship creates added value, which in turn influences the total cost and selling price of the automobile to the final consumer [24]. Material, component and part suppliers—an external group with a great influence on manufacturer performance—play an important role in the automotive industry. They significantly contribute to the total-added value of automobiles, of which around 50% is materials, components and parts for automobile production. Quality and cost are attributes through which the supplier significantly mirrors manufacturer performance and customer satisfaction. This B2B relationship is, therefore, seen not only by purchasers (OEM), but also by the suppliers themselves.

The automotive industry is a sector typically characterized by a relatively long product life cycle. '*Each product is subject to its life cycle, at the end of which it must leave the market and yield its place to a new product*', stated by Tomek and Vávrová [25]. From the current point of view, the life cycle of the product is significantly reducing. This is mainly due to the impact of new discoveries and technologies enabling continual improvement and changes to the product. The lifespan of the product is usually depicted using a product lifespan curve. Its course is not determined by product behaviour, but by the impact of numerous marketing tools, including the influence of other socio-political factors.

The classification of automobiles by class was introduced for reasons of client segmentation. Thanks to this, manufacturers and their organizations can easily define the status of individual models on the market and compare sales performance with comparable competitors. Classification also serves the final consumer for the comparison of different automobile brands during the purchasing decision-making process. An essential precondition for the determination of market position is in the competitive environment of the automotive industry.

The proposed corporate performance management model is based on a situational analysis of the Czech automotive industry. Results from research into the purchase behaviour of Czech automobile customers-consumers (B2C) are used as the data source for measuring satisfaction using the net promoter score (NPS). Measured NPS values are then used to simulate company performance on the basis of the EVA indicator and for the creation of a model.

From the sale categorization point of view, the automobile is a so-called special commodity, which is chosen thoroughly at length by the consumer, who considers and compares before deciding to buy. Besides the qualitative and technical parameters of the car, image and brand are also very important criteria for the choice. The customer-product-performance relationship is essential for the creation of a model. If the price of the product represents revenue, and quality denotes cost, then these variables can also represent the connection between company performance and customer satisfaction.

Findings on some aspects of the supplier-purchaser (OEM) relationship B2B in the automotive industry obtained through guided interviews with company managers engaged in automotive glass production take the character of qualitative research.

Understanding the changes caused by the current unstable global environment should help to adjust the business model to shifting external forces. The environment in which a company works can, according to Osterwalder and Pigneur [26], be seen as a 'certain space' of the design, respectively, a certain context, in which the business model is being created. It is influenced by customers, new technologies, competition and other factors including legislation and regulations [17]. This view allows for a better understanding of how the company works, what it needs to function successfully and, at the same time, ensure stable performance growth for the

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interest groups around it. This model was used as a part of the situation analysis of the Czech automotive industry, the aim of which was to uncover performance growth factors in relation to the behaviour of the Czech customer and owner (user) of the automobile. The results of the situation analysis of the current state of the automotive industry in the Czech Republic and its position on the market according to Osterwalder's model are documented in **Figure 7**.

An online questionnaire survey for users of car was a source of primary data for calculation of satisfaction and loyalty using the net promoter score (NPS) metrics. Measured NPS values showed above-average satisfaction with the cars owned by the respondents. The research also included an analysis of the attributes of overall satisfaction with an automobile, using the philosophy of the three-layered product, the structure of which is demonstrated in **Figure 8**.

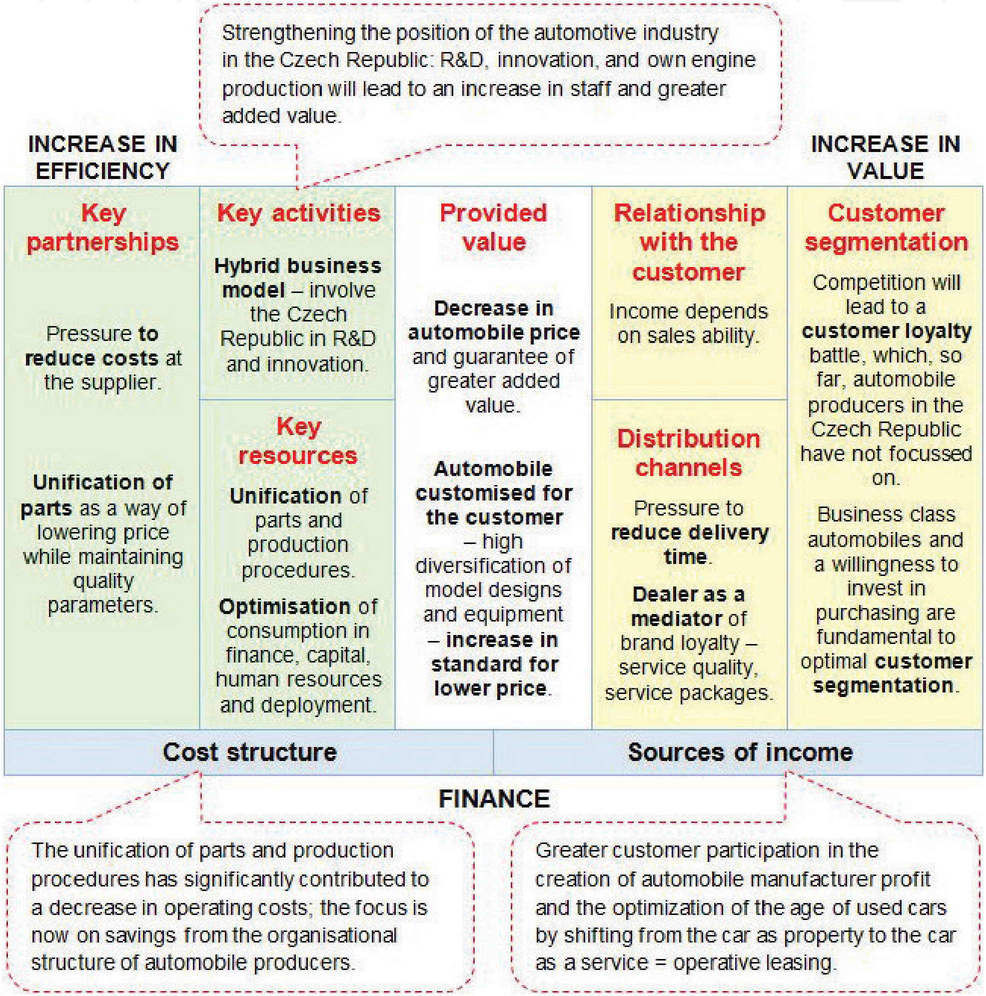

Figure 7. Growth factors of performance in the automotive industry. *Source*: Authors' own adaptation.

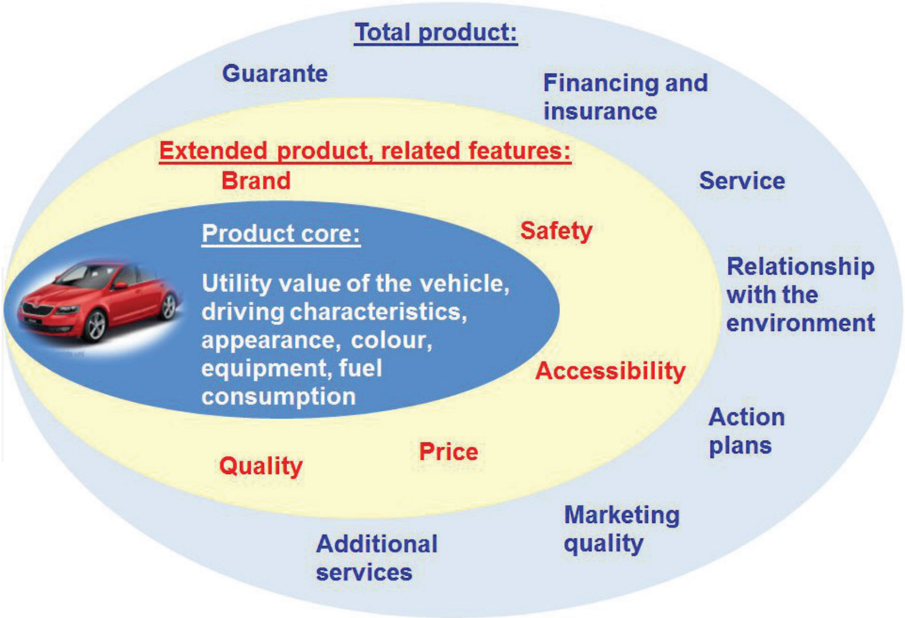

Figure 8. The automobile as a three-layered product. *Source*: Authors' own adaptation.

Respondents rated their satisfaction with their cars in terms of utility value and customer value—the two layers related to automobile manufacturers—as being above-average. Dissatisfaction, however, was related to the third layer, the so-called total product, related to services. The third layer of the product, also reflecting the car dealer's image and culture, shows their share in the forming of the end customer's relationship with the automobile brand in terms of loyalty.

The customer gains more and more importance when strong competition is included. Companies, therefore, endeavour to gain loyalty. The position of a loyal customer can more reliably determine future attitudes and purchase behaviour. In the research, a loyalty analysis of the automobile owned by each respondent was carried out. From a scientific point of view, emotional loyalty is based on the customer's attitude towards the brand and how much they like it. It seems that in the relation to their own car, the respondents expressed emotional loyalty, given by attitudes towards their favourite brands, in contrast to the behavioural loyalty related to the repeated purchase of a brand and its recommendation, desirable for the growth of company performance. The qualitative research also studied the relationship between loyalty and the quality of the automobile brands. The evaluation showed how high the respondents considered the quality of German automobiles. This fact probably also explains the immense loyalty towards German brands, according to NPS values.

The professional community equates customer loyalty to a higher level of satisfaction, with a higher tolerance towards price increase. But this was not proved by the research. The respondents' answers, on the contrary, showed a high sensitivity to price, which is in contrast to the measured NPS values for loyalty. From the discrepancy in loyalty evaluation in relation to price, it may be inferred that behavioural loyalty, leading to repeated car purchase, probably does not play a large role as expected in the purchase decision-making process. The verbal accounts, however, send a signal to automobile manufacturers and vendors on the Czech market: if the car utility value were better, even the Czech customer would be willing to pay more. Tolerance for a higher price of a favourite car brand is linked to the expected value in the core and secondary layers of the product.

It is important to know the correlations between satisfaction, loyalty and individual associated factors for the creation of a proposed model. Factors such as satisfaction and loyalty can reflect perceptions and feelings associated with a product. From the customer value point of view, the respondents attached great importance to quality and safety, evidenced by the strong correlation to total satisfaction. The third layer, services, is a weakness of the automobile as a product.

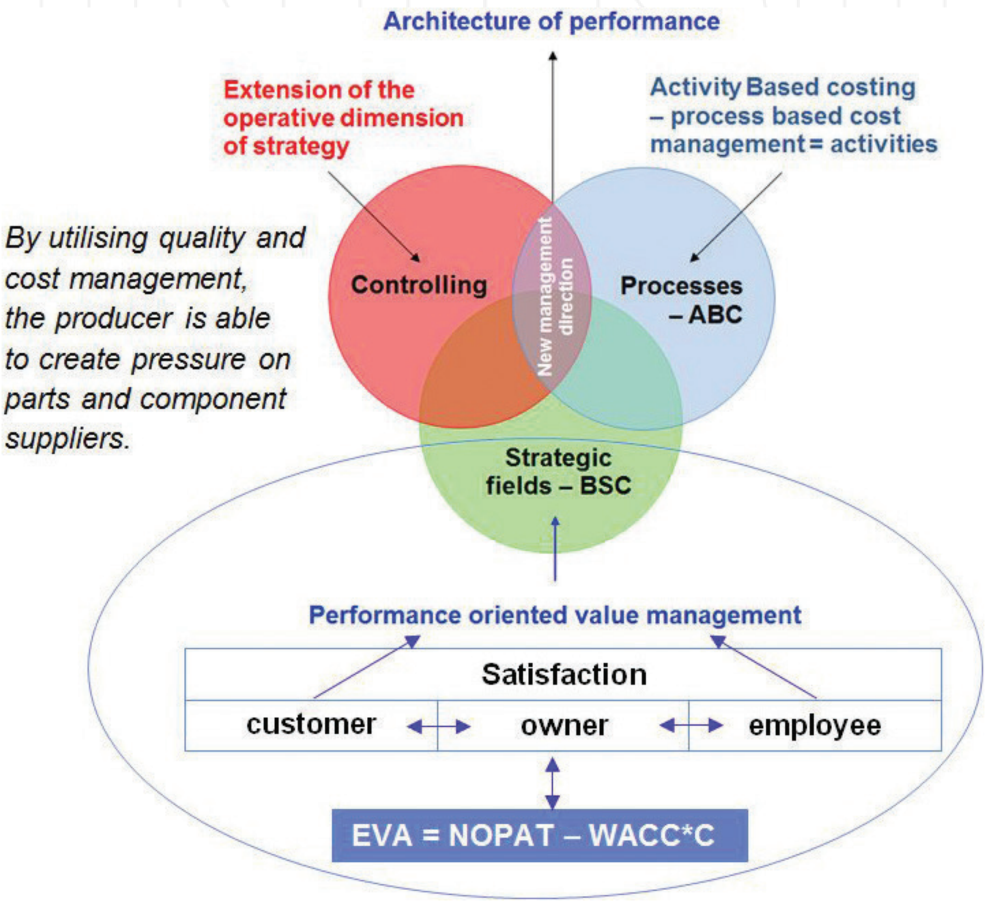

Figure 9. Automotive industry strategic corporate performance management model. *Source*: Authors' own adaptation.

4.2. Model of strategic corporate performance management and its parameters

The presented strategic corporate performance model is set in the environment of so-called 'performance architecture' which integrates controlling, balanced scorecard and activity-based costing. The use of the net promoter score (NPS) for the company performance model is based on customer segmentation, embodied in the very metrics. A proposed corporate performance management model for the automotive industry is shown in **Figure 9**.

The feedback is based on the passive customer segment, through which the improvement of automobile parameters and a transition in satisfaction evaluation into the sympathizer group can be attempted. The bond to the product—the automobile—presented according to Leeflang's theory as the summarization of the attributes of customer satisfaction in its three layers is an important part of the evaluation. In this regard, the attributes with which the customer connects their satisfaction are the moving forces. The price-quality relationship is firmly embedded in the performance-oriented system of the automotive industry management and its strategic orientation. This relationship is very important for customer orientation, but challenges their expertise. '*At a certain point, the customer no longer sees quality increase as an important precondition for paying a higher price for the product*' [12].

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INTECH

Gaining a Competitive Advantage through Green Human Resource Management

Ebru Aykan

Additional information is available at the end of the chapter

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Abstract

The practices of environmental protection and the prevention of environmental pollution have emerged as a result of recent environmental problems when the humans noticed that natural resources are limited. Environmental management practices have accelerated with the conscious acts of businesses on environmental issues since they have the greatest responsibility for environmental pollution. After the 2000s, businesses have started to prefer to be a part of the solution rather than being at the center of the problem and tended to green business and management practices. For improved environmental performance, sustainable competitive advantage, and environmental management, environmental consciousness should be taken into consideration in each and every human resource function ranging from recruitment to training of employees, from performance assessment to rewarding. In this sense, green human resources management (GHRM), allowing improved employee consciousness and commitment to environmental sustainability, has become an interesting issue. In the present study, green human resources management and practices are evaluated, significant issues are pointed out, and recommendations are made for future researchers who wish to work upon this subject.

Keywords: GHRM, competitive advantage, GHRM practices, environmental management, green management

1. Introduction

In today's societies, the concepts like global competition, technological changes and development, communication, environment, and environmental problems are getting more and more common in everyday life with the acceleration of globalization. In this sense, societies, businesses, and individuals develop new dynamics to cope with this global change. Human resource constitutes the primary elements for change and development in organizations. On the other hand, environmental problems occur due to the human perception that the world resources are endless and offer free goods. Today, such problems with various destructive outcomes and impacts have become remarkable. Several environmental disasters, ranging from global warming to droughts, point out the severity of the problem. Significance of environmental problems has brought up the need for environment-conscious (green) activities in individual, organizational, and community levels. These activities are generally implemented on a voluntary basis, but sometimes implemented within the scope of legal obligations.

In the 2000s, businesses began to take conscious acts to contribute to the green movement [1], and the concepts of environmental consciousness and environment-conscious (green) business have evolved. Environment-conscious (green) management as a business concept is defined as a management and business perception in which ecological environment is the primary issue in the activities and decisions of an organization [2], and such concepts targeting the optimum balance between economic and ecologic performance of a business in management are regarded as a process in which all management functions are integrated with environmental protection [3]. In other words, green management and business implies a transition from a perception which does not pay much attention to efficient use of natural resources and the production waste materials released to the environment without any treatment into a perception with an awareness of world's limited natural resources and having and implementing this awareness as a business ethics [4]. An efficient implementation of such a perception has a great significance not only for a sustainable competitive advantage of businesses, but also for the future of mankind. However, the primary actor in making a business sensitive to environmental problems is human, and therefore, full implementation of such a management and business perception will not be possible when the businesses are not able to make their employees conscious about environment [5].

In other words, for improved environmental performance and efficient environment-conscious (green) business, environmental consciousness should be taken into consideration in each and every human resources functions ranging from recruitment to training of employees, from performance assessment to rewarding. Briefly, with green human resources management (GHRM), businesses are able to create a win-win strategy and then can satisfy their employees and improve their environmental performance. Right at this point, identification of implementations and opinions of the business in this subject become a significant matter. As a result, GHRM and its actions are determined as a field of research. In the present study, green human resources management and practices were evaluated, significant issues were pointed out, and recommendations were provided for future researchers who wish to study on this field.

2. Green human resources management (GHRM)

Human resource constitutes a vital function for businesses. Rapid technological changes which occurred after the industrial revolution in the eighteenth century required a specialization in labor force and made human resource a significant aspect of production. Human resource has become a function encompassing entire people employed in the organization.

Today, human resource management undertakes not only recruitment, assessment, dismissal, and similar routine processes but also a managerial function and becomes an inseparable component of management like the other management functions. Therefore, human resource has a strategic significance today. It is quite significant in identification of organization vision, mission, and objectives [6]. In recent years, several businesses have employed a strategic tool known as green human resources management and pro-active implementations to gain a competitive advantage. Environmental management system includes a structure allowing a better control of environmental footprint the businesses leave. GHRM represents the most significant dimension of environmental management system.

Today, the businesses under ever-changing environmental conditions have to develop and implement environment-oriented strategies to gain a sustainable competitive advantage. However, the success of these strategies is totally dependent on proper selections and implementations. In this process, the condition for the success of businesses is the awareness of employee and responsibility in environmental protection. In recent years, businesses are under increasing pressure of environment-conscious production activities, and they have mostly amended their environmental regulation, but they didn't feel necessity to change their human resource management. Therefore, most of the time they experienced various problems in the implementation of their environment-conscious strategies. They have to adapt their human resources factors to the changing conditions while implementing environment-conscious activities such as environment-friendly products, waste management techniques, introduction of green products, and establishment of new relations with various environmental partners. When they are not able to convince and motivate their employees about environmental consciousness, it is impossible to successfully apply such a strategy. In other words, the businesses without human resource who perceives environmental action as a life philosophy and acts accordingly will not be able to have environment-conscious implementations [1]. Therefore, sensitivity and commitment of employees in these programs are the pre-conditions for the success of environment-oriented programs [7]. In this sense, businesses carry out environment-conscious human resources management practices to create an awareness and commitment in their employees.

Green human resource management (GHRM) is considered as a pre-condition for green management and business practices of organizations, and it is pointed out as the critical step for a sustainable competitive advantage. GHRM studies have begun at the end of 1990s and accelerated in the following decades. The relations of environment and environmental management issues with human resources of businesses are placed in literature as follows: Callenbach et al. indicated that within the scope of environmental management, businesses should assign their employees duties to fulfill their environmental responsibilities and should improve their awareness in environmental issues [8]; Welford indicated that environmental management can only be fulfilled through employee participation [9]; Milliman and Clair indicated that environmental management programs should be integrated with human resource management [10]; Wehrmeyer pointed out that an environmental management in a business can only be mentioned when the environmental values of businesses were formed and adopted by human resource professionals and stuffs of the business [11]. The book of Wehrmeyer [11] titled as "Greening People: Human Resources and Environmental Management" and the study of Revill [3] named as "The 'Greening' of Personel/Human Resource Management: An Assessment" are the pioneering works in GHRM literature. Sadgrove mentioned about green human resources managements forming a bond between human resource and environmental management practices [12]; Wehrmeyer classified the functions of green human resource management under the headings of recruitment of authorized stuff, stuff management, and support of organizational dynamics. On the other hand, Milliman and Clair formed a model classifying the functions of green human resource management as strategies, training, performance assessment, and rewarding and pointed out the need for proper organizational structures in which environmental management is harmonized with human resources [13]. Keog and Polonsky indicated that green vision, green objectives, green policy, and programs to fulfill environmental commitments of a business could only be possible through green human resource management [14].

Daily and Huang indicated the significance of human resources for the success of environmental management systems and reported that human resource may influence the performance [15]. Brio and Junquera indicated that environmental management was a quite complex process, but environment-conscious human resources contribute to environmental management [16]. Fernandez et al. emphasized the significance of environmental awareness employees, their participation in environmental activities, and training and motivation for the environmental strategies to be successful [17]. Govindarajulu and Daily claimed the significance of the parameter of human resources in environmental management systems [7]. Boudreau and Ramstad in a study revealed that sustainability principles could be upheld with strategic human resources planning and high level of environmental awareness [18]; however, they also indicated that sufficient interest hasn't been created in this subject in literature. Jabbour and Santos determined human resources as the pre-condition for the success of environment-conscious management of organizations [19]. Akdoğan and Aykan stated that green human resource management practices became functional based on the perspectives of executives about the issue [5]. Mandip described GHRM as a management system integrating environmental management including employee participation and commitment in environmental sustainability with the practices of human resources [20]. According to Mishra et al., GHRM expresses an innovative process including human-oriented technological innovations and developments [21]. While Deshwal described GHRM as an organizational strategy to improve environmental consciousness of employees [22], Renwick et al. [23], Mohd-Yusoff and Mohd-Yusoff [24], Sheopuri and Sheopuri [25], Ahmad [26], Razab et al. [27], Arulrajah et al. [28], and Sharma [29] focused on GHRM practices as the critical success factors, a strategic tool, or a strategy for competitive advantage.

Green human resource management targets human resources to bear an environmental responsibility in their tasks, to turn them into employees who are able to develop positive behaviors with other co-workers, to present new ideas and recommendations, and thus to enable the implementation of environmental programs. The basic target actually is to motivate employees, to turn them into environment-conscious individuals, and to improve environmental performance of the organizations.

The characteristics of traditional human resource management and green human resources management are briefly provided and compared in **Table 1** [3].

	HRM	GHRM
Beliefs and assumptions	Central vision and shared Values Strong culture	Centrally shared environmental Vision Environmental culture
Strategic driven	People Strategic driven Pursuit of excellence and competitive advantage	People Cross-functionally driven pursuit of environmental excellence and sustainable practices
Management direction	Systems structure Supervisory and change leadership Two-way relationship and personal control	Systems structure and institutionalize Policy champion and change leadership two-way relationship and open dialogue
Management direction	Commitment and teamwork Recruitment and selection Appraisal and reward Training, development, and learning	Environmental commitment and teamwork Environmental recruitment and selection Environmental appraisal and reward Environmental training, Development, and learning

Source: Revill [3, p. 4].

Table 1. Comparative analysis of HRM and GHRM.

As it was seen in **Table 1**, the basic difference between human resources management and environment-conscious (green) human resources management is the sustainable and environment-oriented perception in environment-conscious human resources management. While the characteristics like perfection, competitive advantage, and inspector leadership are prominent in human resource management, environmental sustainability and evolutionary leadership that help to develop and implement environmental policies are prominent in environment-conscious human resource management.

Within this perspective in general, green HRM also uses the HRM policies to support the sustainable use of resources within organizations, which contribute to the environment sustainability. The term “Green HRM” is most regularly used to refer to the concern of people about management policies and practices of the broader corporate environmental schedule [22]. Renwick et al. defined GHRM as the human resources dimension of environmental management system and the influence of employees on environmental performance outcomes within the frame of Ability-Motivation-Opportunity (AMO) theory [23] (ability—recruitment and development of highly qualified employees; motivation—improvement of employee commitment and motivation through efficient rewarding and performance management; opportunity—providing employee participation in the process of problem solving by sharing information with them and providing opportunities).

Renwick et al. [33] and Deshwal [22] have explained that GHRM involves an integration of company’s environmental management objectives to the HR processes of recruitment and selection, job description, training and development, health and safety at work, performance management and evaluation, talent management, succession and career planning and rewards, etc. and have highlighted the necessity of implementation of rigorous recruitment and selection of employees, performance-based appraisal system, and introduction of developmental programs aimed at increasing the employees’ environmental awareness.

Zoogah indicated that GHRM makes the human resources practice, philosophy, and policies sustainable business sources [30]; similarly, Ahmad [26] illustrated that GHRM brings the human resources policies into force allowing the sustainable use of resources in every job/process of the business. With another perspective, Mandip [20] and Mishra et al. [21] defined GHRM as the implementations that support environmentalist activities and improve employee consciousness and commitments for environmental sustainability. Besides providing improved efficiency like reduced cost and employee commitment, and improved organizational outcomes, the green human resource management practices include the implementations that reduce the carbon footprint of the business. Then, Mishra et al. [21] defined green human resource management as an innovative process that includes human-related technological innovations and developments. GHRM involves human-related technology advancements and mainly includes initiatives like car-pooling, job-sharing, teleconferencing and virtual interviews, recycling, telecommuting, online training and optimally utilizing the energy-efficient office spaces, etc.

As a result, green human resource management can be defined as the triggering force of the human resource implementations that improves both economic and environmental sustainability of business resources by undertaking change and developing environmental conditions.

3. Green human resources management practices

Since the objectives in GHRM implementations aim to make human resources conscious about environment, to reduce carbon footprint of companies, and to motivate employees to improve their environmental performance, the absence of the implementations of these objectives causes problems in some companies. In such businesses, it is impossible to create an environment-conscious culture and an understanding mindful of environment. With GHRM practices, a business intends to improve productivity, minimize the risks, and protect the interests of shareholders [8].

Wehrmeyer [11] expressed the significance of human resources management in environmental management, significance of employee participation in environmental performance, the complex nature of environmental problems requiring specific analytical and communication skills, and the emergence of environmental management from the needs of cooperation and communication among the entire functions of the organizations. Wehrmeyer [11] described the most significant role of human resources in environmental management as supporting the environmental activities of the organization and classified inter-related human resources functions under two categories including environmental human resources management (EHRM) and environmental management activities [3]. These functions are authorized staff recruitment, staff management, and supporting organizational dynamics (**Table 2**).

Renwick et al. [23] described environmental management as a dimension of human resources management, approached it within the frame of the Ability-Motivation-Opportunity theory (AMO Theory), and grouped GHRM functions under development of green abilities, motivation of green employees, and providing green opportunities (**Table 3**). Razab et al. [27] revealed that environmental consciousness of the businesses was shaped around human resources activities involving entire employees and classified these functions under four

GHRM functions	Activities
Recruitment of authorized personnel	• Job description • Recruitment • Start to work • Dismissal
Personnel management	• Training • Health and safety at work • Personnel assessment • Industrial relations • Motivation and rewarding • Dispute resolution and discipline
Support of organizational dynamics	• Monitoring culture and attitudes • Development of environmental ethics • Support of change management • Developing multi-perspectives • Improving communication
Source: Revill [3, p. 23].	

Table 2. GHRM functions.

headings as recruitment and selection, training and development, performance management system, and waging and rewarding. Mandip [20], Sheopuri and Sheopuri [25], and Mohd-Yusoff and Mohd-Yusoff [24] pointed out that environmental activities of HRM consist of major component of social responsibility of the businesses and assessed these activities within

Developing green abilities	Practices
Green job design and analysis	Incorporating a number of environmental protection-related tasks, duties, and responsibilities in each job and putting into effect.
	Including environmental, social, personal, and technical requirements of the organizations in job descriptions and person (job) specifications as far as possible and put into effect.
	Using teamwork and making cross-functional teams as job design techniques to successfully manage the environmental issues of the company.
	Including environmental dimension as a duty in job description.
	Including green competencies as a special component in job specification. Designing and implementing new jobs and positions in order to focus exclusively on environmental management aspects of the organizations.
Green human resources planning	Engaging in forecasting the number of employees and types of employees, needed to implement the corporate environmental management initiatives/programs/activities (e.g. ISO 14001, cleaner production, responsible care, etc.).
	Engaging in deciding strategies to meet the estimated demand for environmental works (e.g. appointing consultants/experts to perform energy or environmental audit etc.).

Developing green abilities	Practices
Green recruitment	Indicating or making organizations' environmental performance (past and current) transparent in the publication of recruitment announcements.
	Becoming a green employer or green employer of choice.
	Including environmental criteria in the recruitment announcements.
	Asking the employer's concern about greening through recruitment efforts.
	Including the environmental policy and strategies of the organization in its recruitment policy.
	Expressing certain environmental values (e.g. be a part of the green team of ABC or we are socially and environmentally responsible) in the job advertisements of the company.
	Expressing the preference of the organization to recruit the candidates who have competency and willingness to participate in corporate environmental management initiatives in the recruitment announcement.
Green selection	Considering candidates' environmental concern and interest as a selection criterion.
	Asking questions related to environmental issues in the recruitment interviews or in evaluating the candidates·
	Selecting the applicants who are sufficiently aware of greening for the job vacancies.
	Selecting the applicants who have been engaging in greening as consumers in their private life.
Green induction	Providing general green induction.
	Providing job-specific green induction.
	Making the new employees familiar with greening efforts of the organization and encourage them to engage in green interpersonal citizenship behavior.
	Developing induction programs showing green citizenship behavior of current employees.
Green training and development	Providing environmental training to the organizational members (employees and managers) to develop required skills and knowledge.
	Providing training to learn or adapt environmental-friendly best practices (e.g. reducing long-distance business travel and recycling).
	Providing training to create "environmental awareness" among the workforce.
	Providing environmental education to the workforce.
	Providing training to the staff to produce green analysis of work space.
	Applying of job rotation to train green managers of the future.
	Imparting right knowledge and skills about greening (to each employee through a training program exclusively designed for greening).
	Conducting training needs analyses to identify green training needs of employees.
	Analyzing and identifying environmental training needs of employees in order to make them more environmental concerned.
	Conducting a serious and systematic training program which is given to each employee for the purpose of giving the necessary knowledge, skills, and attitudes for good environmental management.
	Providing opportunities to everybody to get training on the aspect of environmental management.

Source: Arulrajah et al. [28, pp. 3–9].

Table 3. Developing green abilities.

the framework of recruitment of environment-conscious employees under the functions of performance management system, training and development, employee participation, conflict and discipline, wage and reward system and appreciation. While Uddin and İslam [31] and Ahmad [26] classified GHRM functions under five categories as green recruitment, green performance management, green training and development, green waging, and green industrial relations, Deshwal [22] added personnel management, ability management, success, and career management to these functions, and thus classified them under eight groups. Arulrajah et al. [28] carried out a review study on the current green human resource practices and gathered these practices under several categories as green job analysis and design, green human resource planning, green recruitment, green selection, green induction, green performance assessment, green training and development, green rewarding system, green job safety, green discipline management, and green employee relations. Below, the GHRM functions were considered within the frame of Ability-Motivation-Opportunity theory (AMO Theory) of Renwick et al. [23] as developing green abilities, motivation of green employees, and providing green opportunities.

3.1. Developing green abilities: attracting and developing talented staff

Development of green abilities attracts environment-conscious and qualified labor force, develops these employees with proper training programs, and places them in a position in which they are able to provide positive organizational outcomes and value-added to the business. At this point, the first step for environmental sustainability is the recruitment and selection of environment-conscious employees.

Businesses should pay special attention to recruitment and selection of employees to work with and with whom they share their vision, mission, objectives, and values. Thus, the activities of the companies are important for the attraction and promotion of conscious employees who have comprehended the environmental objectives and targets of the business well. In this sense, businesses tend to the practices that include job analysis, job design, human resources planning, recruitment, and selection, and then target the training and development of employees.

The objective of training is to let the employees to have certain knowledge, skill, and behaviors and to use all these knowledge in daily activities [1]. Businesses provide environmental knowledge and skills that are necessary for the employees through environmental training programs [6]. Training expresses the effort/efforts planned by the business to ease the learning process of the job-related skills. Such skills involve analytic information, and skills or behaviors for a successful business performance.

Training activities are significant in that they are accepted as the indicator of environmental consciousness. Continuous and publicized trainings significantly influence the public image of the organizations in terms of environmental performance [15].

Success of environmental management systems primarily depends on the consciousness of employees about environmental protection and their comprehension of their role and responsibilities within this process [4]. Special training programs including environmental issues may provide several benefits in defining organizational responsibilities of employees, in creating a positive organizational image, and in providing active participation of employees in environmental management practices [15]. Besides, compliance with legal regulations and laws is also supplied through training practices. In a review study, Arulrajah et al. [28] specified GHRM practices and those that are related to developing green abilities are provided below (**Table 3**).

3.2. Motivating green employees

Employee motivation through rewarding and performance management practices is among the primary functions of GHRM. A well-designed rewarding system is a significant tool to orient employees toward environment-conscious practices. Monetary rewards or publicity for every kind of activities improving environmental performance promotes employees to take environment-related responsibilities and to keep the best practices [1]. Conscious attitudes of executives on environmental issues will also have great impacts on management practices and especially on the behaviors of employees. Each and every implementation ranging from decision making to organizational targets, from employment policies to training and development policies, from business ethics to social responsibility, all are realized under the inspection of executives. The more the executives adopt environmental practices, the more the human resources get conscious about environment and actively engage in green movement along with organizational policies and stay motivated.

The relationships between environmental consciousness and economic success of the business constitute the bases of environmental management system, and the attitudes of executives deeply influence these relations [32]. Executives have the authority to allocate funds to environmental management and thus they have significant influences on medium-level executive since they frequently meet with environmental problems each day and on the other staff with an influence on business activities and processes effecting environment. Support of executives may require the following factors [15]:

- Communication about knowledge, plan, and policies required for employees,
- Promotion of cultural exchanges in activity and implementations,
- Authorizing and rewarding employees for well behaviors and implementations,
- Overview of environmental management processes.

Beside the support of executives in environmental issues, *commitment* also constitutes a significant component. Commitment comes to the forefront in environment-conscious attitudes not only of executives, but also of all employees.

Renwick et al. specified GHRM practices that motivate the employees as follows [33]:

- Monetary-based: bonuses, cash, and premiums.
- Non-monetary-based: sabbatical and leave gifts.
- Recognition-based: awards, dinners, publicity, external roles, and daily praise.
- Positive rewards in environmental management: feedback.
- Personal rewards: Gain green citizenship, connecting suggestion scheme with rewards system, and connecting the participation in green initiatives with career gains.

Performance management practices imply all kind of goods, services, and ideas to achieve pre-specified task and objectives along with business targets. Objectives and such practices also constitute a significant component of employee motivation. The objective herein is to assess environmental performance standards of employees, their participation in environmental friendly business activities, new idea and projects and feedback which are provided for existing problems and to provide new objectives and methods if necessary. Green performance assessment includes the assessments of environmental accidents and performance of environmental responsibilities, environmental issues, and policies [11].

Additionally, establishing environmental management information system (EMIS) and environmental audits, incorporating corporate environmental management objectives and targets with the performance evaluation system of the organization, installing corporate-wide environmental performance standards, integrating green criteria in appraisals or evaluating employee's job performance according to green-related criteria, including a separate component for progress on greening in the performance feedback interview, providing regular feedback to the employees or teams to achieve environmental goals or improve their environmental performance, and introducing or formally evaluating all employees' green job performance are included in environmental assessments for GHRM practices [28].

3.3. Providing green opportunities

The very basic condition for implementation of GHRM and environmental sustainability is adoption and internalization of environmental issues by the entire business. In this sense, it is quite significant to provide the participation and contribution of all employees, from the lowest to highest position, in to the environmental program. Identification of employee attitudes toward environmental issues and turning them into positive behaviors will ease environmental management. Getting the recommendations, expectations, complaints, and ideas of employees on environmental issues [23, 33], increasing their task and authorities, including environmental issues in their job contracts, identification of environmental programs and policies, and announcing them within the organization, creation of green teams will all motivate employees to actively participate in the environmental management. The practices that help to motivate green employees are summarized in **Table 4**.

Authorization on employees basically means transfer of authority by the management instead of keeping it in its hand. In other words, authorization can be expressed as allowing employees to communicate about the business problems and assigning them responsibilities with opportunities related to the subject. In this way, employees will be empowered and allowed to participate in decision-making process and to generate ideas. There are several benefits of employee authorization in businesses [15]:

- Improvements in employee health and safety and in environmental health practices,
- Improvements in economy and organization image,
- Improvements in knowledge of employees and managers, thus empowering employees.

Empowerment of employees first of all prevents them from being a source of pollution. In other words, in an organization that is able to dissipate environmental consciousness to the lowest level, empowered employees as the individuals who know their tasks well will better assess the

Developing green abilities	Motivating green employees	Providing green opportunities
Attracting/selecting • Green issues specified in job descriptions • Green job candidates, applicants use green criteria to select organizations • Green employer branding (green employer of choice) • Firms recruit employees who are "Green aware"—Green issues in induction /socialization processes	*Performance management* • Green performance indicators included in performance management system and appraisals • Communication of green schemes to all levels of staff through PMA scheme, establishing firm-wide dialogue on green matters • Managers/employees are given green targets, goals, and responsibilities • Managers are given objectives on achieving green outcomes included in appraisals • Dis-benefits in performance management system for non-compliance/not meeting EM goals	*Employee involvement* • EI practices in EM including newsletters, suggestion schemes, problem-solving groups, low carbon champions, and green action teams Empowerment and Engagement • Encouraging employees to make suggestions for EM improvements • Increasing employees' psychological empowerment enhances their willingness to make suggestions for EM improvements • Supportive managerial and supervisor behaviors develop employee engagement in EM
Training & development • Employee training in EM to increase awareness, skills, and expertise. • Training for green jobs and integrated training to create an emotional involvement in EM—Trade union representatives get information on EM and union activist EM training • Green knowledge management—using employees' tacit knowledge in EM • Training workshops for managers—Green MBAs • Green leadership style	*Pay and reward systems* • Staff suggestions rewarded in EM • Reward schemes linked to staff gaining EM skills via skill-based payment • Green benefits (transport/travel) rather than pay benefits cards to gain green products • Financial/tax incentives (bicycle loans, use of less polluting cars) • Monetary-based EM reward system • Monthly managerial bonuses for good EM • Including green targets as part of PRP for senior staff • Executive compensation for managers partly based on EM stewardship • Recognition-based rewards in EM for staff (public recognition, awards, paid vacations, time off, gift certificates)	*Supportive climate/culture* • Wider EI in EM underpins pro-environment culture Union role in EI and EM • EM education programs for union members • Joint management/union training programs in EM—Green union representatives

Source: Renwick et al. [23, p. 9].

Table 4. Summary of GHRM practices.

environmental impacts of their tasks and take measures accordingly. Finally, number of knowledgeable employees who prevent pollution and provide solutions is increasing, thus environmental performance of businesses is improving [1]. Thus, qualified human resources have been created.

Team work covers the implementations allowing performance and synergetic corporation of employees along with their abilities. Team work is related to multi-dimensional practices performed in collaboration with common objectives and targets. The teams that are composed of environment-conscious individuals (generally expressed as green teams) are the units created by different groups, individuals, or organizations gathered around various environmental issues and objectives [34]. These teams identify environmental problems, assess them from different perspectives, use a strong communication for the solution of problems, and get together to provide the best solution. Green teams provide several benefits to businesses [34, 35] as follows:

- Creation of new ideas in businesses,
- Improve and ease learning,
- Define environmental problems better and faster,
- Create optimum solutions for these problems.

Green teams inform employees about deeply identification, comprehension, and assessment of environmental issues in businesses and guide them in finding solutions for these problems in a collaboration and coordination.

4. Gaining a competitive advantage through green human resource management

Considering the recent rapid changes and developments, businesses should be more active and innovative in this dynamic process. The pressure of competition and quality through globalization on the one hand and the changing conditions on the other hand force the businesses to change or renovate their business structure, processes, and implementations. Within this system, human resources constitute the primary source of business growth and development; therefore, human resource management becomes more significant. Human resources constitute the driving power for change and renovations in businesses, and they also play a distinctive role in economic, social, and environmental sustainability of the business.

Green human resource management orients the environmental practices toward the protection of environment. Business mission and vision about environmental issues, management philosophy, harmonization of human resources policy and implementations, employee consciousness about the rules and implementation related to environmental protection, and informing and training of employees on these issues are all among the environmental practices of the businesses.

Various sources and capabilities are not sufficient for companies to gain a competitive advantage. Competitive advantage mostly is gained through exclusive capabilities or resources of the business. Therefore, while traditional sources of competitive advantage like natural resources, technology, and scale-economy create a value for the business, source-based approach indicates that these factors could easily be imitated as compared to social structures like personnel system. Indeed, a well-developed human resource management system can be a significant source for competitive advantage. Source-based approach constitutes the theoretical basis for the potential role of human resources as a strategic value. Business tendencies toward the valuable and inimitable internal sources to gain a competitive advantage further increase the strategic significance of human resources [36].

Business consciousness on natural environment developed through the environmental disasters experienced throughout the world and pressures exerted on businesses about environmental consciousness have carried the environmentalist practices of businesses a step further. Green business practices pave the way for an atmosphere with a competitive advantage through economic and environmental sustainability [23]. As a result, business performance is improved, costs are reduced, employee commitment and other organizational outcomes are improved, and carbon footprint of the companies is reduced [23] with GHRM and green human resource practices thanks to increased employee awareness of sustainability. The practices like electronic filing, car-pooling, job-sharing, teleconferencing and virtual interviews, recycling [20] telecommunication technologies, online training, optimal utilization of energy-efficient office spaces, etc. are efficient in reducing the carbon footprint of the businesses. The productivity gained through GHRM practices reduces the operational costs and helps the businesses to be aware of their organizational and social responsibilities [22, 37]. GHRM strictly implements ISO14000 Standards, takes the environmental inspection into account, alters the organizational culture, and helps the employee and producers in creating a business image and a brand.

5. Conclusions

The subject of human resource management includes several issues ranging from organizational design to recruitment activities, from rewarding systems, employee supports, and aid activities to improvement of employees and organization, from performance assessment to waging activities. In addition, green human resource management covers the human resource practices by taking environmental impacts into consideration in all business activities and complying with environmental mission and objectives of the business. Consciousness of employees, as the key stone of organizations, will determine the direction of the business.

Improved environmental performance of the executives to the lowest level workers in an integrative fashion, improved positive communication between the organization and the employees, reduced carbon footprint through monitoring and developing technological innovations and developments, efficient resource utilization, reduced costs, and improved efficiency and productivity can all be used as strategic tools within the scope of GHRM.

When the literature on GHRM was reviewed, it was observed that GHRM functions and practices were considered in various different fashions. The broadest GHRM literature classified GHRM practices under the categories such as green job analysis and design, green human resources planning, green recruitment, green selection, green induction, green performance assessment, green training and development, green rewarding system, green job safety, green discipline management, and green employee relations. The similarities and differences in these practices in different industrial fields and cultures can be elucidated in further studies.

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INTECH

Chapter 9

Earnings Quality and Market Performance in LATAM Corporations: A Combined Agency and Cognitive Approach to Investors' Perceptions of Managerial Information

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Additional information is available at the end of the chapter

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Abstract

This chapter studies the impact of financial reporting quality on firms' market performance in a sample of LATAM corporations. We infer that, especially in contexts of high information asymmetry, investors are not able to effectively discern the quality of the information they are provided with and can therefore be misled in their investment decisions by managerial opportunism. Our theoretical framework is built upon a combined agency theory and cognitive approach. We thereby seek to provide a valuable method to better understand how investors could be making suboptimal choices as a consequence of managers' opportunistic behaviour. Empirically, we use the Generalized Method of Moments (GMM) model, hypothesizing that a positive relationship should be observed between the opportunistic manipulation of earnings (that is, the misuse of accounting accruals) and the firm's market performance (that is, the consequential behaviour of investors). Through this 'pioneering' methodology, applied to the relatively under-researched LATAM region, we find that: (1) Financial data are identifiably and consistently manipulated through discretionary accruals in these countries. (2) As manipulation increases, markets do tend to appear more attractive to investors. (3) The elasticity of the market reaction to this manipulation is higher in what we term 'opaque' countries.

Keywords: corporate governance, earnings quality, market performance, LATAM, agency theory, social cognitive approach

1. Introduction

The best plan is… to profit by the folly of others. Taken from Pliny the Elder, by John Bartlett,

Familiar Quotations, 10th ed. 1909.

Recent corporate scandals across the globe have drawn attention to the field of corporate governance. Users of financial information such as investors, governments and regulators are increasingly concerned about how earnings numbers are derived [1]. This is due in large part to the countless examples of managers who have used their discretionary decision-making power to misreport their firms' profits. Petrobras in Brazil, which overpriced contracts for private benefits, or Disco in Argentina, which was found to have inappropriately recorded the financial results from several joint ventures, are just two examples of high profile firms that have inflated their earnings, to the detriment of investors and in direct contradiction to the provisions of governments and regulators.

This chapter studies the impact of financial reporting quality on firms' market performance in a sample of LATAM corporations, using these data to examine the perception processes of investors as a mediating variable between reporting quality and market performance. Specifically, we address whether the perceived performance of an organization is in reality based upon actual organizational performance, or is instead more a function of the results overtly exhibited in the organization's financial reporting structures, which may have been discretionally manipulated. We propose that, especially in contexts of high asymmetry of information, investors are not able to effectively discern the quality of information provided to them for decision-making purposes and can therefore be easily 'fooled' by managerial opportunism.

Empirically, we base this upon data collected in six Latin American countries by applying the Generalized Method of Moments (GMM) model [2], thereby hypothesizing that a positive relationship will be observed between the opportunistic manipulation of earnings and the firm's market performance. We then examine these results using a lens that combines agency theory with a social cognitive approach, to analyse the manipulated perception process that occurs as a result of that relationship.

There are a number of principal contributions from this chapter. We begin by viewing the process of manipulation with a holistic approach that integrates both a cognitive and agency perspective and allows us to better understand the relationship between earnings management, financial reporting quality and market performance as a whole, thereby providing a more comprehensive vision of the entire process. This contribution is even more valuable because we have situated our study in the under-researched context of Latin America. We also believe that we are the first to apply the GMM methodology in this context, empirically showing how financial manipulation occurs and then impacts upon investor decisions, thus influencing the organization's market valuation. By doing so we have created an algorithm and adapted an overall model that can be more generally used to rank the quality of any earnings reports, thereby contributing to a more transparent market information system. Finally, we hope that our research will go on to inform and serve decision-makers who analyse firms'

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financial statements, as well as act as a catalyst to governments, institutions and policy-makers in deriving policy and promoting market efficiency.

Our most important findings can be summarized to be the following. Our results show: (1) Financial data are identifiably and consistently manipulated through discretionary accruals in these countries. (2) As manipulation increases, markets do tend to appear more attractive to investors. (3) The elasticity of the market reaction to this manipulation is higher in what we term 'opaque' countries.

The steps we take in this chapter begin with our theoretical framework, where we review the relevant literature, illustrate this with a comprehensive model of the overall process and then state our hypothesis. As a second step, we then proceed with the empirical analysis through the operationalization of our baseline model and the construction of our variables. In our third step, we present and discuss our results. We do this by displaying and analysing both the univariate and multivariate analysis and by segmenting the sample into clusters based on the country-level governance system, calling them 'opaque' (lower level of governance) or 'transparent' (higher level of governance) countries. Our conclusions and final remarks are presented at the end of the chapter, where we also address policy recommendations.

2. Theoretical framework

The extent to which financial statements reflect actual operating fundamentals is of growing concern throughout the world, especially in emerging markets where managerial controls and practices can vary substantially from those in the USA or Europe. Some more economically developed countries have passed legislation to ensure better corporate governance and have adopted codes of good conduct in order to reduce the asymmetries of information between shareholders and the firm and to increase the rational component of the decision-making process around choosing one's investments [3, 4]. At the same time, a large difference in the quality of financial reporting across countries has been extensively documented [5]. This has led, according to the behavioural finance approach, to the conclusion that the perception of market participants is likely to be biased as a consequence of the lack of transparency in pricing and the poor quality of financial information [6]. Such losses in the quality of financial information have been modelled through earnings management [7].

Earnings management can be defined as the adjustment of a firm's reported economic performance by insiders, done either to mislead some stakeholders or to influence contractual outcomes [8, 9]. Earnings management is considered to be the most informative and trustworthy to investors if it is supported by what is perceived to be a good system of governance. However, the act of managing earnings does not necessarily reflect the true performance of the company, a situation that may contribute to shareholders and investors making inaccurate judgements about the company [9]. To examine this, we first turn to agency theory, well used in the financial arena, which holds that managerial behaviour can be opportunistic and fuelled by self-interest. Most importantly for our purposes, it accounts for the existence of asymmetries of information between managers and shareholders. Executives accept agent status because they perceive an opportunity to maximize their own utility [10]. Consequently, agency theory holds that managers may take advantage of the information they have and their latitude in making accounting and reporting decisions to overstate financial information. They generally do this by acting in what they perceive to be in their own interest [11]. Reducing agency costs by imposing internal mechanisms of control should therefore encourage managers to behave in the best interest of shareholders instead of in their own interests. However, because controls are imperfect, we would expect some degree of opportunism to remain [10]. Since managers are widely paid based on firm's performance, it is plausible to expect that active earnings manipulation will occur in order to enhance managerial compensation packages [12]. This approach is highly focussed on bounded rational decision making around incentives, information and self-interest. Thus, it is a viewpoint that suggests that it may be necessary to limit managers' discretion with respect to accounting, since investors, as a consequence of asymmetrically distributed market information, cannot unravel the valuation effect of reported earnings in a timely manner under current reporting standards.

We suggest, however, that in addition to agency theory, a more cognitive viewpoint can also be used, to guide and further understand managerial behaviour. Social cognitive theory advocates that behaviour, cognitive and other personal factors and the external environment are the three main factors that drive the decision-making process [13]. These three factors are known to be asymmetrical, similar to the asymmetry of information in agency theory, in that they do not influence each other simultaneously, instantly or with equal strength, but they do influence each other multidirectionally. As a result, both investors and managers can be understood to be making decisions based upon a combination of factors that include a triad of perceptual, environmental and behavioural elements, all converging to ultimately produce an investment decision.

Regarding cognition, two of the most relevant elements related to decision making are managerial biases and heuristics. The most common biases that managers revert to using include representativeness, availability and anchoring-and-adjustment [14] although there are now many other biases and heuristics that have been studied at length in a financial context [15]. The use of heuristics is considered a necessary way for humans to cope with our more limited capacity to process information [16]. More specifically to our study, many researchers have identified the biases and heuristics used in making financial decisions as highly relevant to understand the human and cognitive elements of the processes involved [6, 17]. Thus, according to the social cognitive approach, the market may wrongly perceive the actual firm performance disclosed in financial reports, as a consequence of biases and heuristics held perceptually and socially, in addition to behavioural and environmental elements. Thus, when managers overstate a firm's earnings, due to their bounded rationality and to information asymmetries, they can be easily misled to overprice the firm's shares.

As described in **Figure 1**, by suggesting a complementary relation between agency and social cognition theories, we have produced a model that further explains how this process occurs and shows how the process is reinforced by the lack of sound corporate governance systems in the institutional context of Latin American countries, as is our case.

Financial markets in the region are still in a stage of early development, which allows managers to make use of accounting discretion to manipulate financial information. In immature financial

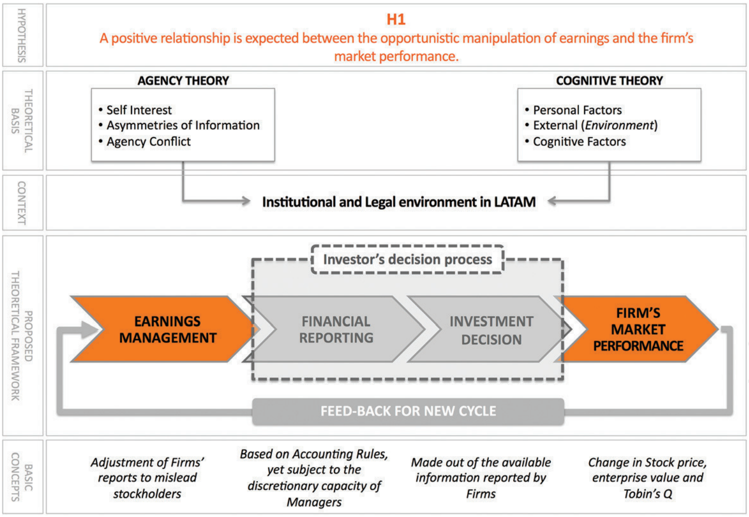

Figure 1. Theoretical and contextual framework, a basis for the operationalized model.

markets, where there are large imbalances of information and opacity, and where the markets are not integrated, investors may not be able to discriminate between companies that provide high or low quality information [18, 19]. Therefore, in the midst of inefficient financial markets in Latin America, managers have more room to manipulate financial statements. Leuz et al. [20] present evidence that the level of outside investor protection endogenously determines the quality of financial information reported to outsiders, showing how legal protection influences the agency conflicts between investors and controlling shareholders. In Latin America investor protection is weak, and this therefore gives insiders more incentives to manipulate earnings. In conclusion, in the institutional context of Latin America, investors suffer more acutely the consequences of earnings manipulation by managers when compared to more developed financial systems, and therefore they may not be able to make optimal investment decisions.

Therefore, based upon the previous arguments regarding agency theory, cognitive theory and the institutional setting in Latin America, we hypothesize that:

H1: A positive relationship is expected between the opportunistic manipulation of earnings and the firm's market performance.

3. Baseline model and empirical analysis

3.1. Sample

The sample we use corresponds to 896 representative large non-financial firms from Argentina, Brazil, Chile, Colombia, Mexico and Peru. Data at firm level are collected from the Thomson Reuters dataset and data at the country level are collected from Worldwide

Governance Indicators obtained from the updated work of Kaufmann et al. [21].[1] The sample corresponds to unbalanced panel data with a total of 9647 firm-year observations over the period from 1997 to 2013.

We use the Generalized Method of Moments (GMM) model to deal with the characteristic econometric problems of unobservable heterogeneity of individual firms and endogeneity [2, 22]. Several statistical contrasts are used as diagnostic tests for our panel data structures (e.g. the Hansen test for the validity of instruments, the second-order serial correlation test AR(2), the Wald test of joint significance of parameters, and the variance inflation factor (VIF) as a formal multicollinearity test). Additionally, non-linear restriction tests are used for those interacted (multiplicative) variables.

3.2. Variable construction

Key to this study is the definition and analysis of our proxy independent variable of earnings manipulation, which corresponds to our measure of managerial discretion and quality of financial reporting. Two alternative estimations of earnings management are used based on absolute discretionary accruals. Since total accruals are known, the discretionary accruals must be estimated. Based on Dechow et al. [23], the total accrual (ACC_{it}) denotes the component of earnings for each i firm during the t period computed as:

$$ACC_{it} = (\Delta CA_{it} - \Delta Cash_{it}) - (\Delta CL_{it} - \Delta STD_{it}) - Dep_{it} \tag{1}$$

where CA denotes current assets, $Cash$ is the cash and cash equivalent, CL are current liabilities, STD stands for short-term debt and the current proportion of long-term debt, and Dep is the annual depreciation expense.

Thus, once the total accruals are calculated, we have to split them into their non-discretionary and discretionary components. Non-discretionary accruals are aimed to improve the informational content of financial statements. According to the Jones [24] model, total accruals are affected by the firm's usual business (which can affect non-cash current assets and liabilities) and by fixed assets (which can affect the depreciation expense). Consequently, ACC are regressed depending on the change in sales ($\Delta Sales_{it}$) and the gross level of property, plant and equipment (PPE_{it}) in the following equation:

$$\frac{ACC_{it}^{Mod1}}{A_{it-1}} = \beta_0 + \beta_1 \frac{\Delta Sales_{it}}{A_{it-1}} + \beta_2 \frac{PPE_{it}}{A_{it-1}} + \varepsilon_{it} \tag{2}$$

Regarding the expected signs for $\beta_1$and β_2 it can be said that this is not trivial, except for β_2, where a negative sign is expected because depreciation has been included with a negative sign in the definition of total accruals (ACC). However, there is no clear prediction for the sign of β_1 because, on the one hand, a higher level of sales might imply higher accounts receivables but, on the other hand, increase in sales usually imply increase in short-term debt too, so the net effect on working capital may not be determined a priori.

[1]The latest update took place in September 2014. Information can be downloaded from www.govindicators.org.

Hence, the value of (ACC) in Eq. (2) is the level of total accruals, depending on the firm's activity and the composition of the firm's assets. Therefore, the error term in the regression, which is the difference between observed and estimated accruals as stated in Eq. (3) would become the part of total accruals that is due to the discretionary behaviour of managers. So the first measure of discretionary accruals ($DACC1_{it}$) should take the form:

$$\left|\frac{DACC1_{it}}{A_{it-1}}\right| = \frac{ACC_{it}}{A_{it-1}} - \left(\hat{\beta}_0 \frac{1}{A_{it-1}} + \hat{\beta}_1 \frac{\Delta Sales_{it}}{A_{it-1}} + \hat{\beta}_2 \frac{PPE_{it}}{A_{it-1}}\right) \tag{3}$$

where $\hat{\beta}_0$, $\hat{\beta}_1$, and $\hat{\beta}_2$ are the estimators for β_0, β_1, and β_2 coefficients, respectively. Since the discretionary behaviour in earnings management may be used either to increase or reduce earnings, we follow Gabrielsen et al. [25] and calculate the absolute value for $DACC$ to measure the extent of this discretionary behaviour instead of its direction.

Similarly, and as stated earlier, our second proxy measure of discretionary accruals also follows a cross-sectional model based on the Jones [24] model as described by Dechow et al. [23] as:

$$\frac{ACC_{it}}{A_{it-1}} = \beta_0 + \beta_1 \frac{\Delta Sales_{it} - \Delta AR_{it}}{A_{it-1}} + \beta_2 \frac{PPE_{it}}{A_{it-1}} + \varepsilon_{it} \tag{4}$$

The coefficient estimates from Eq. (4) are used to estimate the firm-specific non-discretional accruals as:

$$NDACC_{it} = \hat{\beta}_0 \frac{1}{A_{it-1}} + \hat{\beta}_1 \frac{\Delta Sales_{it} - \Delta AR_{it}}{A_{it-1}} + \hat{\beta}_2 \frac{PPE_{it}}{A_{it-1}} \tag{5}$$

where ΔAR_{it} is the change in accounts receivable from the preceding year. Following Cohen et al. [26], while computing the non-discretionary accruals, we adjust the reported revenues on the sample of firms for the change in accounts receivable to capture any potential accounting discretion arising from sale credits. Then, the second measure of discretionary accruals is the difference between total accruals and the fitted non-discretionary accruals ($DACC2_{it}$), defined as:

$$\left|\frac{DACC2_{it}}{A_{it-1}}\right| = \frac{ACC_{it}}{A_{it-1}} - \left(\hat{\beta}_0 \frac{1}{A_{it-1}} + \hat{\beta}_1 \frac{\Delta Sales_{it} - \Delta AR_{it}}{A_{it-1}} + \hat{\beta}_2 \frac{PPE_{it}}{A_{it-1}}\right) \tag{6}$$

Similar to the first measure, we also compute discretionary accruals in their absolute values.

In our models, the firm market performance as a dependent variable is computed through a number of alternative measures. First, we use the market return ($MP1_{it}$) calculated as the annual change in the stock price for the firm i in the period t. The second measure of performance is based on the enterprise value ($MP2_{it}$) calculated as the market capitalization, plus debt, minority interests and preferred shares, minus cash and cash equivalent for the firm i in the period t. To avoid the bias produced by scale issues, the enterprise value is computed in logarithms, which is the usual transformation applied to positive values with high dispersion. Finally, in our third measure of market performance we used the Tobin's Q. Due to this variable typically being unobservable by outsiders, a common practice is to rely on proxy variables. For doing so, we used the construct performed by Perfect and Wiles [27] which considers the reposition cost of total assets. Accordingly, the firm performance is:

$$MP3_{it} = \frac{MkCptz_{it} + TD_{it}}{K_{it}} \tag{7}$$

where $MkCptz_{it}$ is the market capitalization computed as the product between the year-end close price per share and the number of shares outstanding per i firm; TD_{it} is the total liabilities at the year t; and K_{it} is the replacement value of firms' assets which is estimated by Perfect and Wiles [27] as follows:

$$K_{it} = RNP_{it} + RINV_{it} + (TA_{it} - BNP_{it} - BINV_{it}) \tag{8}$$

where RNP_{it} is the replacement cost of net property, plant and equipment (net fixed assets); $RINV_{it}$ is the replacement value of inventories, TA_{it} is the total assets; BNP_{it} is the book value of net property, plant and equipment; and $BINV_{it}$ is the book value of inventories.

$$RNP_{it} = RNP_{it-1}\left[\frac{1+\phi_t}{1+\delta_{it}}\right] + I_{it} \tag{9}$$

For $t > t_0$ where t_0 is the first year of observations for a given company in this study; whilst $RNP_{it_0} = BNP_{it_0}$. Moreover, φ_t is the growth of capital good prices in year t which is defined by the Gross Domestic Product (GDP) deflactor. In other words, $\phi_t = \frac{NomGDP_t}{RealGDP_t}100$, where $NomGDP_t$ is the nominal GDP and $RealGDP_t$ is the real GDP, both reported by the National Institute of Statistics of Chile. δ_{it} is the real depreciation rate defined as $\delta_{it} = \frac{Dep_{it}}{BNP_{it}}$, where Dep_{it} is the annual book depreciation. I_{it} is the new investment in property, plant and equipment or capital expenditure which is defined as $I_{it} = BNP_{it} - BNP_{it-1} + Dep_{it}$.

$$RINV_{it} = BINV_{it}\left[\frac{2WPI_t}{WPI_t + WPI_{t-1}}\right] \tag{10}$$

where WPI_t is the wholesale price index by country reported by the World Bank. This estimation for the replacement value of inventories assumes that the inventory accounting method is the average cost. For this method, the value of inventories reported at time t is approximately equal to the average of the prices at $t-1$ and t.

The other independent variables correspond to control variables entered into the model in order to avoid problems of misspecification. The first control variable corresponds to the leverage at book value (LEV_{it}) measured as the total liabilities over total assets, the company size ($SIZE_{it}$) calculated as the logarithmic transformation of total assets, the firm's profitability (ROA_{it}) measured as the earnings before interest and taxes over total assets, and finally we include the company's default risk ($RISK_{it}$) which is measured through the alternative Altman [28] Z-Score which was specifically derived for developing countries computed as:

$$RISK_{it} = 6.56WC_{it} + 3.26RE_{it} + 6.72EBIT_{it} + 1.05BVE_{it} + 3.25 \tag{11}$$

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where WC_{it} is the working capital over total assets, RE_{it} is the retained earnings over total assets, $EBIT_{it}$ is the earnings before interest and taxes and BVE_{it} is the book value of equity over total liabilities.

For country-level variables we use the Worldwide Governance Index[2] ($GOVINDEX_t$) computed by Kaufmann et al. [21] as a measure of transparency across countries. This index is a composite of six dimensions of governance including: (i) Voice and Accountability, which are the process by which governments are selected, monitored and replaced; (ii) Political Stability and Absence of Violence/Terrorism, which measure the perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including politically-motivated violence and terrorism; (iii) Government Effectiveness corresponds to the quality of public and civil services, and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies; (iv) Regulatory Quality, which measures the perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development; (v) Rule of Law, which reflects the confidence that the agents will abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence; and finally (vi) the Control of Corruption, which measures the perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as capture of the state by elites and private interests. All of these six individual indicators are between −2.5 and 2.5 with increasing values as the governance indicator improves. GOVINDEX therefore corresponds to the average value among these six governance indicators by country and year.

Therefore, our estimation model would take the following form:

$$MP_{it} = \beta_0 + \beta_1 DACC_{it-1} + \beta_2 CV_{it} + \eta_i + \mu_t + \varepsilon_{it}, \tag{12}$$

where MP_{it} is the market performance, $DACC_{it-1}$ is the one-period lagged discretionary accruals measure, CV_{it} is a vector of control variables (e.g. LEV_{it}, $SIZE_{it}$, ROA_{it}, and $RISK_{it}$), η_i is the individual fixed effect, μ_t is the time effect and ε_{it} is the stochastic error term. $GOVINDEX_t$ variable is used to split the sample and estimate separate regressions. Additionally, country, industry and time dummy variables are included in the model.

4. Empirical results

4.1. Univariate analysis

For the empirical results we proceed in two parts. As a starting point, in order to make the empirical analysis significant, we have to test the null hypothesis that the mean values of the discretionary accruals measures are statistically significant from zero. Previous literature suggests that managers of companies with weak governance structures have greater discretion to

[2]The latest update took place in September 2015. Information can be downloaded from www.govindicators.org.

engage in opportunistic earnings management [29]. A similar situation is observed when the regulatory environment does not efficiently constrain management's flexibility to misrepresent financial results [30]. The p-values reported in **Table 1** suggest that the mean values of our alternative measures of discretionary accruals are significantly different from zero. In accordance with the previous literate, therefore, this preliminary finding may be used as evidence that listed firms in our sample opportunistically manipulate their financial reports.

Additionally, we split the sample into two big groups depending on the average value of the GOVINDEX variable by country. Although not reported, the average values were negative for all the countries, except for Chile and Brazil. Consequently, we can state that for the group of countries comprised of Chile and Brazil the transparency and corporate governance rules are relatively more efficient than for Argentina, Colombia, Mexico and Peru. Thus, the sample slip corresponds to these two groups, namely 'Transparent Countries' for those countries with relatively better transparency and corporate governance, and 'Opaque Countries' corresponding to those with relatively worse transparency and corporate governance. As observed in **Table 2**, the mean difference test was applied to verify if the extent of discretionary accruals as a measure of financial overstatement is the same across the two groups. The null hypothesis is that there is no difference in discretionary accruals between the two groups and the alternative hypothesis is that discretionary accruals are greater in the group of countries with relatively weaker transparency and governance. As tabulated, DACC1 is statistically greater in the set of countries which are less transparent and where corporate governance is weaker (e.g. Argentina, Colombia, Mexico and Peru, all of which we call the 'Opaque Countries') than in the set of countries such as Chile and Brazil where institutional transparency and corporate governance are better, and which we term the 'Transparent Countries'. This is shown to provide evidence that more financial statement manipulation is present when institutions and governance are weaker.

The descriptive statistics in **Table 3** show that for our three measures of market performance (e.g. MP1, MP2 and MP3) there are positive average values for the companies included in the sample. Additionally, a typical company finances its total assets with about 48.73% of debt. In our sample, companies achieve an average rate of return of 4.27% on total assets. Finally, the average indicator of transparency and quality of corporate governance (GOVINDEX) is only 0.2146 with a maximum coefficient of 1.2482, which is still far away from its theoretical maximum achievable designated to be 2.5 [21].

The matrix of correlation coefficients is exhibited in **Table 4**. As would be expected, there is a high correlation for some measures of performance, such as the 0.533 correlation coefficient between MP2 and MP3. Similarly, high correlations are observed between the measures of discretionary accruals. On the other hand, we do not observe relatively high levels of correlation between the explanatory variables, with the exception of the correlation between the firm size (SIZE) and its leverage (LEV) (e.g. significant correlation of 0.408) and between firms' default risk (RISK) and the level of debt (LEV) (e.g. significant correlation of 0.691).[3] These slightly high correlations might eventually cause problems of multicollinearity in the

[3]Although the tabulated correlation is negative, its interpretation is in the opposite direction as a consequence of the construction of the RISK variable where the firm risk increases as the variable decreases.

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Variables	Obs	Mean	Std. error	Std. dev.	*P*-value
DACC1	9635	0.0217	0.0002	0.0239	0.0000
DACC2	9635	0.0260	0.0004	0.0385	0.0000
DACC3	9635	0.0276	0.0003	0.0257	0.0000

This table shows the contrast to test the null hypothesis H_0 that mean values for discretionary accruals measures are zero. The alternative hypothesis H_a is that such values are positive.

Table 1. One-sample *t* test.

Variables	Countries	Obs	Mean	Std. error	Std. dev.	Difference	Ha: diff > 0
DACC1	Opaque countries	4002	0.0224	0.0004	0.0223	0.0012	0.0070
	Transparent countries	5633	0.0212	0.0003	0.0249		
DACC2	Opaque countries	4002	0.0262	0.0005	0.0316	0.0002	0.3770
	Transparent countries	5633	0.0259	0.0006	0.0428		
DACC3	Opaque countries	4002	0.0280	0.0004	0.0261	0.0006	0.1120
	Transparent countries	5633	0.0273	0.0003	0.0254		

This table tests the null hypothesis H_0 that the difference in mean values for discretionary accruals measures are the same between 'Other Countries' and 'Chile + Brazil' groups. The alternative hypothesis H_a is that this difference is positive.

Table 2. Two groups test with equal variances.

Variable	Mean	Std. dev.	Min	Max
MP1	0.1272	0.4908	−0.8700	1.9984
MP2	8.7660	3.2880	0.0010	16.9760
MP3	6.4865	2.0207	0.0058	11.9799
DACC1	0.0217	0.0239	0.0000	0.3838
DACC2	0.0260	0.0385	0.0000	0.7007
DACC3	0.0276	0.0257	0.0000	0.2895
LEV	0.4873	0.2349	0.0072	0.9467
SIZE	6.1524	2.0842	−2.0887	13.2225
ROA	0.0427	0.0945	−0.4515	0.4948
RISK	7.2761	5.3480	0.1667	33.0204
GOVINDEX	0.2146	0.5851	−0.6658	1.2482

This table shows the descriptive statistics (e.g. mean value, standard deviation, minimum and maximum) for the variables used in the empirical analysis.

Table 3. Descriptive statistics of variables.

Variables	MP1	MP2	MP3	DACC1	DACC2	DACC3	LEV	SIZE	ROA	RISK
MP2	0.040	1.000								
	(0.000)									
MP3	0.030	0.533	1.000							
	(0.004)	(0.000)								
DACC1	−0.028	0.025	−0.065	1.000						
	(0.007)	(0.019)	(0.000)							
DACC2	−0.033	0.015	−0.068	0.934	1.000					
	(0.001)	(0.168)	(0.000)	(0.000)						
DACC3	−0.036	−0.036	−0.121	0.859	0.839	1.000				
	(0.001)	(0.001)	(0.000)	(0.000)	(0.000)					
LEV	−0.014	0.016	0.358	−0.125	−0.080	−0.103	1.000			
	(0.165)	(0.135)	(0.000)	(0.000)	(0.000)	(0.000)				
SIZE	0.031	0.528	0.965	−0.085	−0.074	−0.136	0.408	1.000		
	(0.003)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)			
ROA	0.184	0.115	0.012	−0.003	−0.005	−0.029	−0.274	0.004	1.000	
	(0.000)	(0.000)	(0.266)	(0.744)	(0.626)	(0.005)	(0.000)	(0.709)		
RISK	0.044	−0.015	−0.238	−0.041	−0.020	−0.0362	−0.691	−0.284	0.334	1.000
	(0.000)	(0.147)	(0.000)	(0.000)	(0.050)	(0.001)	(0.000)	(0.000)	(0.000)	
GOVINDEX	−0.050	0.535	−0.088	−0.065	0.060	0.042	−0.176	−0.115	0.057	0.139
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)

The table reports the pairwise correlation coefficient matrix. The significance level of each correlation coefficient is in parenthesis.

Table 4. Pairwise correlation coefficients.

regression estimates. Nevertheless, as reported in the subsequent regression tables, the variance inflation factor (VIF) test allows us to accept the hypothesis of the inexistence of this econometric problem.

4.2. Multivariate analysis

Concerning the multivariate analysis, we interpret the outcomes of the model (12) for the whole sample according to the regression estimates shown in **Table 5**. This table includes nine regressions for our three alternative measures of the dependent variable (e.g. MP1, MP2 and MP3) explained by our three one-period lagged independent variables as measures of the quality of the financial reports and earnings manipulation (e.g. DACC1, DACC2 and DACC3). As a starting point for the interpretation of the coefficient estimates in our regression analysis, a battery of diagnostic tests is used to ensure the validity of our results in **Tables 5** and **6**. Robust standard errors were used in all the regression estimates. According to the Wald test, all the independent variables are jointly significant at the standard confidence levels. As mentioned

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Variables	MP1	MP1	MP1	MP2	MP2	MP2	MP3	MP2	MP3
$DACC1_{t-1}$	2.1660			6.2290***			2.1726***		
	(1.3985)			(6.0160)			(4.6340)		
$DACC2_{t-1}$		6.0404***			5.1725***			0.3698	
		(3.6418)			(9.2875)			(1.6330)	
$DACC3_{t-1}$			6.6370***			0.5416			0.5009**
			(3.3999)			(1.0670)			(−2.3382)
LEV	−2.7174	−3.8098	9.3240	3.9353***	5.5361***	1.5004***	1.7003***	1.5353***	1.5901***
	(−0.7238)	(−0.9337)	(0.7826)	(11.4338)	(15.2080)	(5.6679)	(10.3436)	(10.6859)	(11.4474)
SIZE	−0.5093	−0.3941	−1.2559	1.1193***	1.2469***	1.0573***	0.9666***	0.9670***	0.9491***
	(−1.0917)	(−0.7404)	(−1.3556)	(25.8565)	(28.5999)	(29.8487)	(72.3698)	(69.9110)	(82.4417)
ROA	2.2433	8.8811***	7.1137***	0.0855	0.7537**	2.5251***	0.0410	0.4219***	0.5651***
	(0.4507)	(2.6688)	(4.2203)	(0.2407)	(−2.2683)	(8.2591)	(0.3049)	(3.0741)	(4.4991)
RISK	0.6709**	0.7802***	0.5878	−0.0101	0.0571***	0.0554***	0.0182***	0.0029	0.0145**
	(2.0610)	(2.6424)	(0.6086)	(−1.3095)	(5.6442)	(4.7087)	(2.9191)	(0.4227)	(2.4912)
Constant	−0.6884	−3.6828	−7.4544	3.7492***	4.1199***	3.1807***	−0.5662***	−0.3507***	−0.3625***
	(−0.1412)	(−0.6646)	(−0.5519)	(13.6469)	(14.1623)	(12.9888)	(−4.5775)	(−2.6674)	(−3.3534)
Observations	8848	8848	8848	8965	8965	8965	9608	9608	9608
Number of iden	886	886	886	908	908	908	895	895	895
Wald test	10.860***	15.337***	12.138***	577.000***	242.250***	671.023***	112.337***	62.253***	332.902***
AR(2)	0.202	0.170	0.148	0.423	0.396	0.477	0.860	0.510	0.578
Hansen test	49.950	112.740	96.312	276.400	161.599	130.220	325.322	161.830	147.520
VIF	1.73	1.03	1.29	1.15	0.98	1.29	1.18	1.17	1.30

This table includes the estimations of model (12). Variables construction is described in Section 3.2. Industry, time and country effects are included in the estimations but not tabulated. The Wald test of statistical significance of independent variables is reported at the bottom of the table. Similarly, the second-order autocorrelation test is reported (AR(2)). The Hansen contrast is used to test the hypothesis that the instruments are properly chosen. The VIF test is used to formally examine the multicollinearity problem. Standard errors are in parentheses.
*Statistical significance at the 10% level.
**Statistical significance at the 5% level.
***Statistical significance at the 1% level.

Table 5. Multivariate analysis for the whole sample.

above, the variance inflation factor (VIF) reported at the bottom of **Tables 5** and **6** confirm that collinearity does not skew our estimation results since the VIFs are greater than 2. Regarding the moment conditions, the Hansen over-identification tests did not reject the over-identifying restrictions, meaning that we accept the null hypothesis of validity of the instruments in our estimations. Additionally, the AR(2) test proves the lack of second-order serial correlation. Consequently, our results are not biased by a possible incorrect choice of instruments or by autocorrelation and are robust, according to the standard diagnostic tests for panel data.

Variables	MP1	MP1	MP1	MP2	MP2	MP2	MP3	MP3	MP3
$DACC1_{t-1}$	7.059**			1.6018***			1.7355*		
	(0.9151)			(5.7779)			(1.8141)		
$DACC1_{t-1}{}^{*}SYS$	−4.9041*			−0.4964***			−0.8013***		
	(−0.7209)			(−12.9280)			(−5.6391)		
$DACC1_{t-1}+DACC1_{t-1}{}^{*}SYS$	*2.1549**			*1.1054****			*0.9342**		
$DACC2_{t-1}$		3.5026***			0.7596*			5.3086***	
		(3.2505)			(9.2927)			(5.2294)	
$DACC2_{t-1}{}^{*}SYST$		−1.9704***			−0.6997**			−4.2790***	
		(−3.1764)			(−15.7794)			(−6.9984)	
$DACC2_{t-1}+DACC2_{t-1}{}^{*}SYS$		*1.5322****			*0.0599***			*1.0296****	
$DACC3_{t-1}$			2.0647***			0.4148***			3.2447***
			(3.0704)			(9.9215)			(3.7770)
$DACC3_{t-1}{}^{*}SYST$			−1.1733***			−0.1247*			−2.7271*
			(−2.7950)			(−11.9847)			(−3.6554)
$DACC2_{t-1}+DACC2_{t-1}{}^{*}SYS$			*0.8914****			*0.2901**			*0.5176***
LEV	−1.6711	−10.1574	−3.8463	4.3005***	5.2190***	0.4523	1.6498***	1.7214***	1.6522***
	(−0.2296)	(−1.6045)	(−0.2746)	(11.3608)	(14.3559)	(1.2470)	(10.4653)	(11.5689)	(10.5313)
SIZE	−0.7768	0.6852	0.3946	1.0962***	1.1786***	1.0024***	0.9617***	0.9405***	0.9377***
	(−0.8334)	(0.7225)	(0.2922)	(25.2228)	(27.2567)	(25.3953)	(64.1562)	(63.9162)	(75.0594)
ROA	9.0907	17.2895**	42.4076**	−0.2355	0.6890**	2.4617***	0.0619	0.3948**	0.5256***
	(0.8169)	(2.1722)	(2.0678)	(−0.6157)	(−2.1810)	(6.4494)	(0.4093)	(2.3561)	(3.4411)
RISK	0.2831*	0.8423**	1.1136	−0.0159	0.0709***	0.0629***	0.0143**	0.0029	0.0109
	(0.5280)	(2.4286)	(1.0804)	(−1.4665)	(6.2080)	(4.0482)	(2.1930)	(0.3744)	(1.5524)
Constant	2.5543	−9.2934	−16.1757	4.0527***	4.5408***	3.1268***	−0.4891***	−0.2535*	−0.2807**
	(0.2844)	(−1.1314)	(−0.9620)	(13.4278)	(15.6612)	(10.2658)	(−3.9125)	(−1.8302)	(−2.2376)

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Variables	MP1	MP1	MP1	MP2	MP2	MP2	MP3	MP3	MP3
Observations	8848	8848	8848	8965	8965	8965	9608	9608	9608
Number of iden	886	886	886	908	908	908	895	895	895
Wald test	762.470***	527.150***	649.033***	112.934***	270.732***	174.122***	133.826***	84.724***	137.590***
AR(2)	0.998	1.124	1.490	1.859	1.460	1.385	0.994	1.137	1.280
Hansen test	153.300	166.920	211.965	193.836	103.570	140.242	178.103	148.049	195.624
VIF	1.121	1.205	1.380	1.094	1.183	1.124	1.150	0.902	1.661

This table includes the estimations of model (12) including the interacted variables for discretionary accruals and the country-level governance index. The significance of the linear combinations of coefficients of these variables is tested and reported in the estimates in italics. The construction of variables is described in Section 3.2. Industry, time and country effects are included in the estimations but not tabulated. The Wald test of statistical significance of the independent variable is reported at the bottom of the table. Similarly, the second-order autocorrelation test is reported (AR(2)). The Hansen contrast is used to test the hypothesis that the instruments are properly chosen. The VIF test is used to formally examine the multicollinearity problem. Standard errors are in parentheses.

*Statistical significance at the 10% level.

**Statistical significance at the 5% level.

***Statistical significance at the 1% level.

Table 6. Multivariate analysis by levels of governance.

4.2.1. Discussion of results of the whole sample

Concerning the findings, the results systematically show that higher manipulation of financial reports (DACC1, DACC2 or DACC3) leads to greater firm market performance (MP1, MP2 and MP3). Although in regressions (1), (6) and (8) our measures of discretionary accruals are not statistically significant, the direction of the relationship is still positive (e.g. see **Table 5**). For instance, in the second regression, we observe that an increase by one percentage point in our first one-period lagged measure of discretionary accruals ($DACC1_{t-1}$) triggers an increase of 6.0404 times the market change in the stock price. Such a large change in market prices caused by a small change in earnings management is evidence of an elastic market performance. According to Leuz et al. [20], earnings management can be defined as the alteration of firms' reported economic performance by insiders to either mislead outsiders or to influence contractual outcomes. Our results provide evidence of this construct suggesting that when managers overstate or misreport financial statements by actively manipulating earnings, there is a market premium as a consequence of a general lack of transparency in the LATAM context [21], and investor biases, despite some distinctive levels of transparence, are observed in the region. We observe that the stock price change (MP1), the logarithmic transformation of the enterprise value (MP2), as well as the performance measure proxied by Tobin's Q (MP3), all serve to increase the manipulation of financial reports.

Our results also support the Lee et al. [9] model, where firms with higher accounting performance over-report earnings by a larger amount when looking for greater price responsiveness or market performance. In the Lee et al. [9] model, managers manage earnings to influence the stock price. This is a plausible explanation for our results. We suggest that under a rational setting that is free of market frictions, where information is symmetrically distributed and where there is complete alignment of interest between managers and shareholders, there is no room for managers to opportunistically manage earnings to increase market performance. Under these conditions, the market would be able to discriminate and choose a separating equilibrium as suggested by Akerlof [18], by rationally discounting for the over-statement of earnings. This supports the idea that buyers are guided by earnings but are unaware that earnings are inflated by the generous use of accruals, and that this is a consequence of individual biases, wrong perceptions and misuse of heuristics in making their financial decisions. Thus, investors are misled to pay too high a price [31], which triggers a greater change in stock price, enterprise value and Tobin's Q. Hence, when there is a lack of transparency and the agency conflict is not efficiently minimized, managers take advantage of their discretionary power to artificially boost the market performance of the company. The major motivation behind this is basically the improvement of contractual conditions and reward with better compensation packages. Or as stated in terms of Teoh et al. [31], managers manage earnings to exploit market credulity. This idea is consistent with investors naively extrapolating earnings without fully adjusting for the potential manipulation of reported earnings [32]. Consequently, the previous findings allow us to accept our research hypothesis that there will be a positive relationship between opportunistic manipulation of earnings and firms' market performance.

Concerning the control variables included in the model specifications, we observe that leverage (LEV) does not impact on the stock price change (MP1), but it has a positive relationship with our two other alternative measures of market performance, namely the enterprise value (MP2) and the proxy for Tobin's Q (MP3). As suggested by the capital structure literature, debt can be efficiently used to undertake profitable investment projects that the market interprets as positive growth opportunities by pushing up the market valuation [33]. Similarly, the size of the company (SIZE) is also positively related to its performance. According to our findings, larger firms take advantage of economies of scale and this dimension is rewarded with a premium in market valuation. The return on assets (ROA) is also positively associated with the market performance. Consequently, there is a direct correspondence between the bottom-line net income and the firms' stock performance. Regarding our last control variable, the default risk (RISK) is found to be negatively associated with market performance. As mentioned earlier, by construction, the RISK variable increases as the default risk decreases, and consequently, the results reported in **Tables 5** and **6** must be interpreted in the opposite direction. Hence, our findings suggest that the market discounts prices when the firm is approaching bankruptcy as suggested by the literature [28, 34].

4.2.2. Discussion of results by levels of governance

In this section on multivariate analysis, we aim to study the impact of different levels of transparency and efficiency of country-level governance systems on the relationship between earnings management and the firms' market performance. As has been widely supported in previous literature, governance systems in the Latin American region are comparatively weaker than in other more developed economies such as the US or Europe [35–37]. Consequently, such opaqueness in the financial markets and the weaker protection of investor rights determines how actively managers over-state financial information disclosed to the markets [38]. Moreover, differences in governance systems have also been observed across Latin American countries [39].

To disentangle this issue we add to our estimation model (12) a variable that allows us to control for cross-country differences in governance systems and transparency. To do so, we create a dummy variable (SYS) based on the subsamples of 'Transparent Countries' and 'Opaque Countries' described in Section 4.2. This dummy variable takes the value 1 if the country belongs to the subsample of 'Transparent Countries' and zero for the subsample of 'Opaque Countries'. Afterwards, we interact the SYS variable with our alternative measures of discretionary accruals and create a multiplicative variable, for instance, $DACC_{t-1}$*SYS. This variable allows us to measure the specific impact of discretionary accruals on firm performance moderated by the two different levels of cross-country transparency and governance defined in our sample.

The results reported in **Table 6** indicate, on the one hand, that the one-period lagged variable of discretionary accruals is always positively related to market performance. On the other hand, the interacted or multiplicative variables between discretionary accruals and transparency and governance efficiency (see for instance $DACC_{t-1}$*SYS in the first regression in **Table 6**) consistently show a negative relationship with firm performance. The interpretation of these results are as follows. Taking the first regression in **Table 6**, for the subsample of 'Transparent Countries', namely Brazil and Chile, the SYS variable takes the value 1 and consequently the impact of discretionary accruals on the firm's performance corresponds to the addition of $DACC_{t-1}$ and $DACC_{t-1}$*SYS (=$DACC_{t-1}$ + $DACC_{t-1}$*SYS) which is reported in the table in italic characters. In the first regression, this addition of variables takes a value equal to 2.1549. Consequently, for the 'Transparent Countries', a marginal increase in earnings management ($DACC_{t-1}$) causes more than twice an impact on the change in stock price (MP1). However, since SYS takes a zero value for the group of 'Opaque Countries', the impact of discretionary accruals on market performance for this subset of countries corresponds only to the coefficient estimate of the $DACC_{t-1}$ variable, which in the first regression goes up to 7.059. Thus, before any marginal change in opportunistic managerial behaviour is measured through discretionary accruals, the impact on the change in price will be more than seven times the change in discretionary accruals. The significance of the linear combinations of coefficients is tested and it is accepted in all cases that the addition of the discretionary accruals variables and the interacted or multiplicative variables are statistically different from zero (e.g. see italic characters in **Table 6**).

In all the subsequent regression estimates of **Table 6**, we observe that the impact on any measure of market performance (MP1, MP2 or MP3) as a consequence of a change in the discretionary accruals is systematically greater in the group of 'Opaque Countries' than in the group of 'Transparent Countries'. This may be used as robust evidence that managers take more advantage of market myopia when institutional settings are endowed with weaker governance systems and where greater gaps of information exist between insiders and outsiders. In other words, although we subscribe to previous literature on the fact that governance systems are relatively weak in the Latin American region [40], we also recognize that there are still some intraregional differences in transparency and governance, as supported by our findings. Thus, in more transparent financial systems and where the right of shareholders is relatively better protected, the impact on market performance caused by opportunistic manipulation of financial reports is not as large as in contexts of less transparency and governance. We can derive out of this finding that the market is fooled in order to increase the firm's valuation by mispresenting the financial information. And even more, the weaker the governance systems across countries in the Latin American region, the greater the changes will be to boost firm value by misleading the market towards making wrong investment decisions.

Finally, findings concerning the control variables listed in **Table 6** remain consistent with those previously interpreted based on **Table 5**. Thus, we can conclude that our overall findings are robust to a battery of alternative test specifications and controls, as well as to elaborate dependent and independent variables.

5. Conclusions and final remarks

The main goal of this chapter has been to measure the impact of earnings management and reporting on market performance. We have sought to examine this phenomenon in a holistic way. Far from a purely statistical correlation analysis, we have sought to examine the phenomenon in light of theories that support this from a management point of view, in an attempt to merge the two together.

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The two major theories we have applied include agency theory and social cognitive theory. According to Eisenhardt [12], agency theory is particularly effective when coupled with complementary perspectives. We have therefore created a theoretical model that serves to illustrate our operational model, by showing how this process happens as a whole. While it does describe our two mediating variables, financial reporting quality and investment decision making, we conceptually consider these to be a 'black box' that then allows us to focus more on the relationship of the two variables in the extremes of the model, earnings management and stock performance. Overall, our approach seeks to show how both a cognitive and an agency approach can be used together to demonstrate how a firm's earnings quality can impact on its market performance.

A number of policy recommendations are derived from our findings. First, regulators and those who set accounting standards may find these results useful for assessing the levels of discretion that should be permitted to corporate managers for adjusting their financial reports. Second, our results suggest that individual investors will behave more rationally and be more aware in their investing decisions if the impact of discretionary accruals on the stock price is made more apparent. Overall, we argue that there is a clear need for more transparent financial markets and enhanced corporate governance measures.

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Chapter 10

Universities as Corporate Entities: The Role of Social Responsibility in Their Strategic Management

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Additional information is available at the end of the chapter

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Abstract

Universities, as educational institutions, play a vital role in the development and improvement of the society, contributing to the welfare of citizens. Considering the social responsibility of universities with a large number of stakeholders (students, institutions, government, employees, companies, local community, etc.), this chapter aims to examine how these institutions establish the mission, objectives and strategic actions oriented at meeting these expectations. In this line, university in its daily management is also considered a corporate entity, which set up strategic plans and practices, an essential process to achieve its success in the long term. The chapter explores the necessary steps for adjusting these strategic plans to the new challeng e of introducing a socially responsible orientation in their management.

Keywords: corporate social responsibility, higher education institutions, strategic plans, university social responsibility, strategy, university strategic management, university stakeholders

1. Introduction

Nowadays, the lack of social responsible actions of the institutions and companies provokes that researchers explore the value of ethical behavior for society. In its role, university plays an essential role in the development of educational strategies, having a greater responsibility as a consequence. The term university social responsibility (USR) is explained as the capacity of higher education institutions (HEIs) to disseminate and implement a set of principles, general and specific values aimed at enhancing the educational and social challenges of the society through four key processes: management, teaching, research and extension [1].

Moreover, the role of universities is essential in the social development for the knowledge-based economy [2], assuming a strategic role in the welfare of the nations. The HEIs are considered relevant for their capacity to affect a great kind of interest groups (students, communities and society in general). Hence, USR represents an opportunity to promote the social development from the heart of the university.

However, in order to take advantages from this opportunity, it is important that academic authorities and public institutions use strategic plans which include and allow to manage and meet all of the stakeholders' requirements in the university work.

Considering this background, the chapter proposes a conceptual model which analyzes the inclusion of USR in the university management. For this study, the business scope has been taken, considering different contributions in the field of corporate social responsibility (CSR) and the way in which it has been extrapolated to the education sector. The stakeholder theory is considered as an important theory in the chapter. The stakeholders can be defined as all groups that influence or are influenced by the objectives, actions, political decisions and goals of a given organization with legitimate interests entitled to intervene [3–7].

Thus, it is assumed that decision-making affects in general a whole social system composed by different parties [8], lying in this the importance of the USR, for its high degree of impact on society. Other efforts to integrate CSR into decision-making were made by Porter and Kramer in their study "Creating Sharing Value." They stated that organizations should seek to coordinate their business with social needs and challenges, creating value not only in the company, but also in its environment [9], which demonstrates once again the effort to meet social requirements.

From a strategic point of view, USR represents an opportunity for social development, and in general in all their roles of action and in their multiple scope of impact such as organizational, educational, knowledge and social fields [10, 11]. Thus, due to the wide area of influence, in the development of USR, it is critical to formulate strategies designed to meet the needs of its various stakeholders, orienting the mission, objectives and specific actions to USR. In this chapter, it is suggested that USR actions are strategic whether they meet five specific conditions: (1) they are coordinated with the institution's mission and objectives; (2) they produce a differentiating position for the university; (3) they anticipate the needs of the stakeholders; (4) they are not been imposed by external norms and (5) when those actions are easily visible by stakeholders [12].

Moreover, a content analysis between two Spanish universities is made in order to provide evidence of the strategic inclusion of USR in university strategic plans. The content analysis reports as a main conclusion the existence of specific USR lines as well as a wide number of stakeholders identified in the development of these actions. The result is emphasized in the relevance of stakeholder theory for USR. Specifically, the model highlights the introduction of USR into strategic plan as a management tool, creating a dynamic that benefits all stakeholders.

Finally, the development of the chapter is distributed as follows. Firstly, an analysis of the transition from the CSR concept to the USR is made. In Section 3, we examine the USR inclusion in the university strategic management. In Section 4, the USR is explained based on the foundations of stakeholder theory. Section 5 presents the methods used in the content analysis. Section 6 reports the conceptual proposal. Finally, the conclusions and future research lines are discussed at the end of the chapter.

2. From corporate social responsibility to university social responsibility

The understanding of USR concept needs a review of the previous concept CSR. Therefore, it is essential to know the evolution of the CSR in order to contextualize the field of USR for HEIs.

The contributions of Howard Bowen, considered the father of the CSR [13], stated that businessmen's decision-making affects the society. With this statement, he established the basis of CSR, defining it as the obligations of businessmen to carry out desirable actions for society [14]. It can be seen that, from its beginnings, the *raison d'être* of CSR is to consider the impact of the policies, strategies and in general the organizational work.

In the 1960s, the CSR is evolving, conceiving business actions beyond economic interests in a managerial context [15]. In the educational context, in its first conceptualization, the USR concept has arisen in the university management to attract students and economic profits as a consequence. However, universities as public institutions have social obligations beyond legal and economic duties in areas like the political and educational aimed at achieving the welfare of society [16]. In this sense, compliance with the CSR is achieved by considering the needs of all stakeholders affected by the activity of the company, since institutional decision-making affects the entire social system [8].

The evolution of CSR leads to its relationship with voluntarism [17], disappearing any chance of seeing it as an attraction of economic benefits, as Davis [15] pointed out. In this context, universities have a social role and service to the community, so it is necessary to discuss the voluntary nature of the USR and its transition to compulsory. Regarding CSR definition, some works report that the compliance with the CSR is achieved meeting the social goals of citizens, as well as explain that the responsibility of the company depends on their size, having large companies more responsibility than small ones [18]. It is understandable for the university sector that responsibilities are also bigger regarding the size of the institution, since it has a greater impact on the environment and it affects the daily work in a greater number of people.

In the 1980s, the CSR concept was conceived as a process being defined as a "decision making procedure which constitute a CSR behaviour" (p. 66) [19]. Thus, as the CSR has evolved over time, it has been adapted to different types of organization, with diverse activity in different periods of time [20]. An important contribution is made by Porter and Kramer [9], establishing that a way to rethink the relationship between society and corporate performance is through "the creation of shared value." In this line, the authors reinforced the idea that organizations must create a greater understanding of social needs, remodeling capitalism with social relationships [9]. This goes beyond the philanthropy and specific CSR actions.

The development of the USR has been smaller than the development of CSR in private companies [21]. However, the USR studies are gaining attention and value for the necessary promotion and development of civil values and responsibilities [22]. Particularly, this attention is focused on the university capability to influence on the education of citizens in a globalized world [23], and on the university goal of building a fairer society [24]. According to these facts, social responsibility justifies its application within universities.

Unlike the CSR, the USR arises from the concern of the educational sector to contribute to social development and the impacts of HEIs. This process must be taken into account through a participatory dialogue with society in order to promote sustainable development [25]. USR should be planned as a policy of continuous improvement of the university toward the effective fulfilment of its social mission through its different management areas: (1) the organizational scope, as an entity with its own structure that consumes, has staff employed and generates waste; (2) the educational scope as an entity that is responsible for the students training; (3) the knowledge scope, as an entity that researches, producing know-how and transmitting it; and (4) the social scope as an entity which interacts with others agents, communities and social subsystems [10, 11].

Thus, the importance of the university has been increasing, since these institutions have been pressured to act in a socially responsible way due to the important educational role that they play in the society. This process has been reflected in the third mission of the university based on the transfer of knowledge to society, meeting also its social demands [26].

From a theoretical perspective, the approaches which analyze the USR are diverse. According to Gaete, we identified three main approaches [27]:

1. Managerial approach, which analyzes the impact of university work, strengthens the relations between universities and stakeholders [28, 29].
2. Transformational approach, which links the HEIs with the contribution to the debate and reflection through research and training [30].
3. Normative approach, which fosters and promotes the university values to society through national and international networks.

Furthermore, another interesting framework is developed in the corporate citizenship theory, which concerns about the duties of the company as part of society and the integrative theories that explain that the company works to satisfy the social demands of stakeholders [31]. In this case, universities as organizations operate within society and influence different stakeholders also have rights and obligations and must be managed, taking into consideration the needs of different university stakeholders.

The inclusion of USR into university strategic management is reviewed as follows.

3. The inclusion of USR in university strategic management

In order to study the USR field within HEIs, it is necessary to understand how the work of the university and the inclusion of USR in strategic management are.

First, we determine how the university strategic management performs its functions. It has been suggested that in many educational institutions strategic planning is only a short-term planning that seeks to solve specific problems and not necessarily seek the development of strategic projects [32]. Strategic planning allows HEIs to benefit from the opportunities, using resources strategically and also helping to future plans [33].

At this point, it should be wondered to know whether universities have benefited from the opportunities offered by strategic planning and whether they have taken into account their management of resources. Likewise, strategic planning also provides a sense of autonomy, facilitating decision-making process and improving the communication [34]. Moreover, several studies that support the strategic management in HEIs are becoming more numerous and diverse, mainly because of a greater demand in economic efficiency, as well as the search for a higher quality of teaching and research [35–38].

Although strategic planning is a common process implemented among HEIs, it is difficult to find a method that indicates the degree of success [39]. In addition, the literature does not identify a standardized methodology that determines the effectiveness of strategic planning or institutional learning strategies [40], and unfortunately when the strategic plan is already established, many HEIs fail to execute it [41]. Hence, the degree to which strategic planning is used is important for institutional success [42]. However, to achieve this success, the support of academic departments is necessary [43]. Also, each HEI needs different strategies due to the fact that every university has different needs and resources of each particular environment, because each institution has diverse fields of action and multiple stakeholders.

Now, we should understand how the university work is. First, we have to state their public nature, assuming responsibilities toward society [44], as well as social, environmental and economic concerns [45]. The formulation of university strategies must take into account these needs [45], including them in the mission, goals, objectives, lines of action and other components that form the strategic plan [46]. In other words, university uses a strategic management process, being particularly important the definition of the strategy, as well as its design, implementation, evaluation and control. This process is shown in **Figure 1**.

Thus, the strategic plan, as a management tool [64], helps HEIs to establish a university mission, to identify their goals and objectives and to seek actions that help achieve what is established. Such actions must be oriented toward social responsibility, due to their nature.

The place of the USR within this strategic management is reflected when the development of the mission, objectives and specific strategic actions are taking place. Academic authorities take into account and considerate the impacts of the university work to the stakeholders, as well as to evaluate and control such management. Consequently, the USR is inherent in the entire process of strategic management.

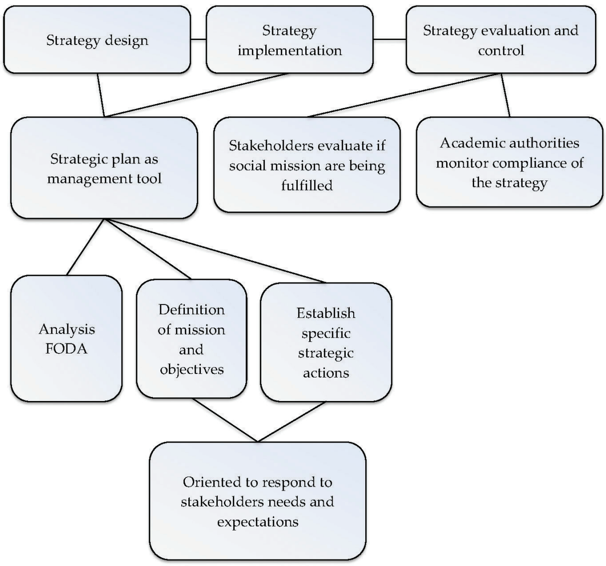

Figure 1. Social responsibility into the strategic management process based on Refs. [47, 48].

In private companies, social responsibility actions are considered strategic if they carry on a benefit to the company, are closely related to the business activities and accomplish its mission [12]. In the university case, the actions that involve the USR are also strategic when they support their social legitimacy. Burke and Logsdon [12] identified five characteristics of strategic activities oriented to social responsibility strategic actions:

1. Centrality, which refers to the proximity between CSR's activities with the mission and objectives.
2. Specificity, which is the capacity of CSR activities to benefit the organization, giving a differential position.
3. Proactivity, which provides the capacity of CSR activities to anticipate the expectations and needs of stakeholders.
4. Voluntarism, which is achieved when CSR activities have not been imposed by external standards.
5. Visibility, capacity of CSR activities to be easily located by their stakeholders.

In the same way, USR activities can be strategic or not. The analysis of the previous authors has value for this chapter, because linking the university strategy with the USR leads to the formalization of the USR into the strategic management.

4. Explanation of USR through stakeholder's theory

The reason for existence of the USR is based on the fulfilment of the needs and expectations of the stakeholders, so it is crucial to study this theory and understand who are those groups and their influence on the university work. Stakeholder theory explains that there are groups that influence or are influenced by the objectives, actions, political decisions and goals of a given organization. Also, there are groups with legitimate interests that are allowed to interfere [3–7].

According to Reavill [49] in the case of universities, the main stakeholders are as follows:

1. Students and families
2. University administrative staff and faculty
3. Suppliers of goods and services
4. Educational sector
5. Other universities
6. Commerce and industry
7. The nation
8. The government
9. Local and national taxpayers
10. Authorities and professional bodies

In order to correctly implement USR in HEIs, it is necessary to consider all university stakeholders in the management of different areas, being useful the basis of stakeholder theory to understand this phenomenon [50]. On the other hand, it is important to understand the influence of these groups on the university.

Different authors have classified this influence in different terms:

1. Theory of stakeholder salience [51], distinguishing those stakeholders according to the urgency for immediate actions, the influence or power of the stakeholders in the development of concrete actions [51, 52], and the legitimacy with the activities that they perform in the institution.
2. Some authors claim that all stakeholders are equal, and none has priority over another [3, 53, 54].
3. Others studies suggest that organizations must recognize what are the critical resources affected by these groups, making it necessary to develop different strategies for meeting these primary interests [55–57].

As a result, the previous authors conclude that some groups are more important than others due to their influence of critical resources:

1. Other classifications are based on whether these groups belong to the internal or external membership of the organization [58, 59], and finally

2. Classifies stakeholders considering their participation into an organization [60] as internal actors (participation in internal management), as stake-watchers (generate influence/pressure in the development of activities), and as stake-keepers (impose external control).

As it was mentioned before, the USR value is due to the benefits it brings to the stakeholders' community. In this perception, students and their legitimacy in university tasks deserve special attention, above all because they represent a significant consumer when obtaining the necessary training to perform professionally, benefiting from a better and responsible system of HEIs. Other stakeholders are benefited too, like academics and administrative staff by improving their training and management work. In the case of society, the achievement of graduates ready for facing the ethical challenges and values needed in the market is important, among others.

Once we have analyzed these groups, it is important to examine how HEIs can manage these relationships with their stakeholders, carrying out pro-action strategies which include social responsibility [56, 61]. The third university mission in the knowledge-based economy [2] involves reconsidering relationships with different stakeholders and then establishing working relationships with each group [59]. Based on the previous background, the strategic management and planning of USR must propose an efficient management as a result of a strategic fit between corporate strategy and social responsibility, able to meet the social and wide demands of society.

Thus, when a university seeks to be competitive, it needs to rethink whether its activities meet the needs of its stakeholders and perhaps need to build stronger strategic relationships with its stakeholders to respond to changes in the education sector [62].

5. Methods and results

Based on the fact that the university has different stakeholders, a deeper study about their environment deserves more attention. This can be understood as areas of university impact, organizational, educative, social and cognitive scope [10, 11], explained as follows:

1. Organizational scope, related to the responsibilities that HEIs have toward teaching, research, administrative and services staff; in this sense, the university has an important responsibility role of administration.

2. Educational scope, related to the responsible education of students and building the profile of graduates.

University of Cadiz (Cadiz)	Polytechnic University of Catalonia (Barcelona)
• Coordination and elaboration of a social responsibility program • The promotion and technical support to the evaluation and certification of the services and administrative units in collaboration with the general inspection of services and with the management • The elaboration of the objectives and action plans of the library and the General Directorate of Information Systems • The elaboration of the objectives, action plans and management criteria of the Publications Service of the University of Cadiz • Coordination of the Program for the Promotion of Books, Reading and Writing • Coordination of the relationships with former students • Participation in Health Promotion Programs, coordinating volunteer projects • The promotion of participation, volunteering and social commitment of the university community, cooperation with the associative fabric, as well as attention to diversity, especially in the areas of disability, culture and social disadvantage • Coordination of cooperation programs for development, immigration, culture and the promotion of human rights and social and solidarity action • The management of the Office for Sustainability • Coordination of environmental policies, sustainability and energy efficiency, with the collaboration of Management and the General Directorate of Infrastructure and Heritage • Coordination and preparation of the Annual Report of the University of Cadiz, subject to verification by an independent certification agency • Coordination of university sports, with the aim of contributing to the integral development of people • Improving student training by developing it on the principles of the Fair Play Program • The promotion and management of cultural activities that involve the participation of members of the university community • Collaboration with public and private institutions for the dissemination of culture in society with seasonal programs	• Integration of the competition “Sustainability and social commitment” in the studies of degree • Creation of the STEP 2015 Program • Creation of the VISCA Teaching Innovation Group • Studies related to the dimensions of social responsibility • International Campus of Energy for Excellence • Research Groups linked to Social Responsibility • The important contribution of the community and the creation of an internal network of units, forums, debate, promotion and dissemination around the paradigm of social responsibility

Table 1. Comparison of USR practices between UCA and UPC.

3. Social scope, referred to the participation of universities into society activities to boost plenty welfare into its community.
4. Cognitive scope, related to the generation of knowledge that contributes to solve social challenges, linked with theoretical approaches, lines of research, processes of production and dissemination of knowledge.

Thus, when universities evaluate their impacts, it can be considered that university implements a cycle of continuous improvements toward the effective fulfilment of its social mission through four processes: (1) ethical and environmental management of the institution; (2) formation of responsible and supportive citizens; (3) production and dissemination of socially relevant knowledge and (4) social participation in promoting a more humane and sustainable development model [10]. Therefore, we must also emphasize that the importance of the USR comes from the commitment to society where HEIs must generate a dynamic of change toward a more fair society [63].

This chapter in order to provide evidences of the USR practices and their integration in university strategic programs made a content analysis of the web pages of the authors of the contribution. A content analysis of the University of Cadiz—UCA—and Polytechnic University of Catalonia—UPC—allows the identification of several USR practices (**Table 1**).

Source: USR practices extracted from the web pages of the universities, UCA: http://www.uca.es/vrsocial/funciones and UPC: https://www.upc.edu/rsu/es/eliminar/las-acciones-que-hacemos-en-la-upc

In both universities, we identified several cultural, environmental and educational activities related to the integration of social responsibility in university activities. Most of these activities are focusing in two of the most important stakeholder groups for the universities: the employee's staff and the students. In the specific case of the UPC, the web page classified these activities in four specific groups, aimed at satisfying and introducing socially responsible orientation in: research, teaching, organization and reflection. This classification allows us to identify what are the key strategic areas in the implementation of socially responsible practices in universities.

Most of these USR practices also meet the conditions of Burke and Logsdon [12], because they take part from the central aim of the universities, can give a differential position to them, provide the capacity to anticipate future stakeholder expectations and are voluntary and visible in the university web pages.

Despite the fact that the content analysis is limited to two universities, it represents the first step in the identification of USR activities as well as their integration into strategic programs and plans of universities. Hence, we proposed the use of USR management tool for those universities, which are interested in integrating responsible initiatives.

6. Proposal of USR management tool

In order to develop USR in a proper and formal way within HEIs, social responsibility should be introduced in the strategic planning of the university [64]. In this line, the HEIs are managed by the university strategic management, which is composed by the technical and human team in charge of managing activities related to the university work and tasks. This process is implemented in cyclical steps through three important sections: planning, execution and evaluation at different levels (institutional, sectorial, unit and individual) [65].

Moreover, university strategic management must include in its strategic plan the mission, vision and definition of objectives and actions, ensuring an appropriate use of resources to serve to its social mission and the development of internal and external diagnostics. The conceptual proposal is presented as follows (**Figure 2**).

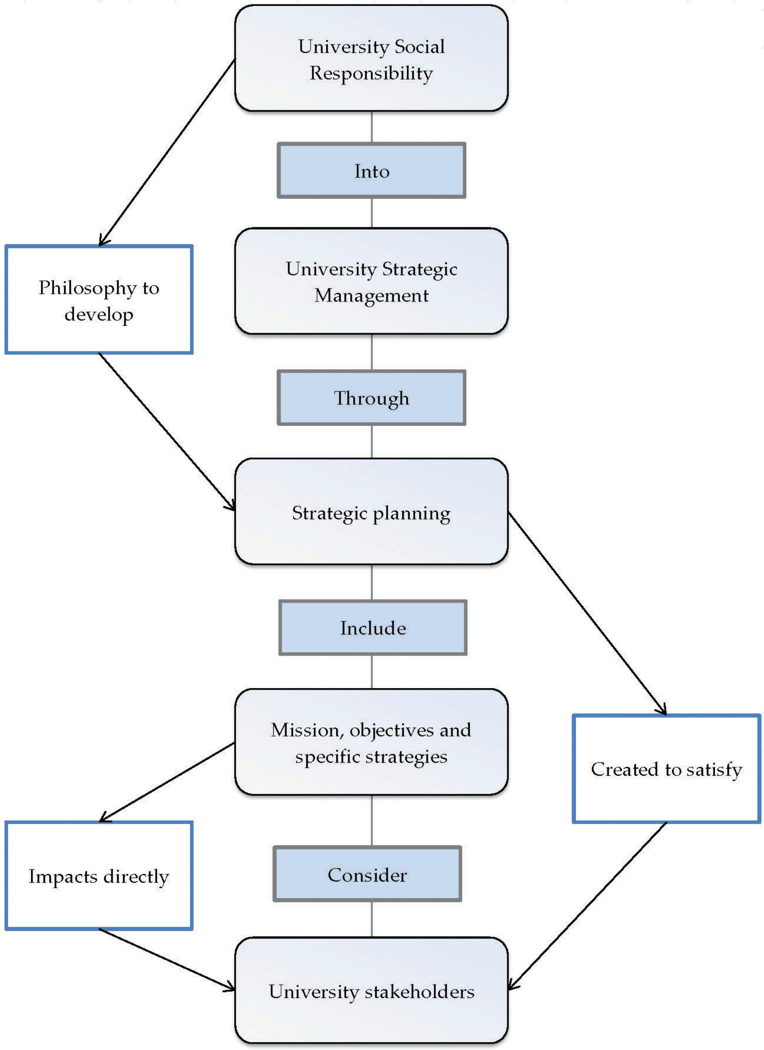

Figure 2. Role of the USR into the universities.

Therefore, it is necessary to identify how this perception could be included in the strategic plan, which includes mainly the integration of USR as philosophy of planning strategic actions (**Figure 2**). University strategic management should be oriented to evaluate the fulfilment of the needs and expectations of the stakeholders tracing the course of the university, which must be based on the USR.

Thus, university strategic management will succeed if managers are able to respond to stakeholder's needs and create welfare and if they are capable of gaining trust and generating cooperation between all university stakeholders.

7. Conclusions and future research lines

The aim of this chapter is the formal inclusion of the university social responsibility into strategic management, presenting an innovative conception of formulating strategies based on stakeholder's needs.

University potential comes from the perception of its labor on educating future professionals, but higher education institutions have much more impact beyond that. This study highlights the potential of universities throw USR, by giving more attention to the academic authorities that make strategic decisions within the university.

Their strategic decisions affect to multiple stakeholders into organizational, educative, social and cognitive scopes, and the importance of this issue also comes from the perception that universities are a good opportunity to generate society welfare; on the basis that university strategic management is constantly in a decision-making process. One important suggestion of this chapter is to include the university social responsibility as an inherent part of this decision-making, considering every impact that university could cause from its strategic decision.

Several contributions from corporate responsibility have been taken to explain the implementation of social responsibility into universities, such as "the creation of shared value" [9], where companies look forward the integration of social needs into daily work, creating value for organizations and for society.

Also as special contribution of this chapter we based on strategic management process: design, implementation, evaluation and control [47, 48]. In this process, it is proposed to establish an orientation of the mission, objectives and specific strategic aimed at achieving university goals and evaluate if the social mission of university is fulfilled.

In the same line, USR in the content analysis we made meets the conditions of Burke and Logsdon [12]: centrality, specificity, proactivity, voluntarism and visibility, suggesting that there is not too much difference between the CSR implementation and USR implementation in the practice. The work of Burke and Logsdon plays a relevant role in the identification of strategic USR practices. Moreover, the content analysis shed light on the identification of four strategic sections for implementing socially responsible actions: teaching, researching organization and reflection concerns.

Thus, the only way for USR to increase the university values is to be integrated into the strategic management of universities as a formal process. The university decision makers must establish a mission, objectives and specific strategic actions to respond to stakeholder's needs and expectations and coordinate all process by using the strategic plan as management tool. Once they create this plan, they should execute it and evaluate if university work truly accomplishes the stakeholder requirements. Consequently, university social responsibility should be placed as a philosophy to develop the strategic plan, and authorities should implement strategies anticipating stakeholder's expectation.

Therefore, the complexity of this issue deserves more analysis in its different aspects, such as current demands of university stakeholders and how universities meet the expectations; what is the situation of USR into the university strategic management in other Spanish and European universities; and knowing from university decision makers whether they are really interested in implementing USR initiatives and monitoring these activities. These issues have to be considered by all people interested in university performance and development in future research lines.

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