Corporate Governance and Risk Management

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1st edition

ISBN 978-87-7681-668-1

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1 Introduction

It is clearly accepted that good corporate governance is fundamental to the successfully continuing operating of any company; hence much attention has been paid to the procedures of such governance. Often however what is actually meant by the corporate governance of a firm is merely assumed without being made explicit; often it is assumed to be concerned with how the company conducts its annual meeting, deals with auditors etc. Increasingly this has been extended into a more general concern with the management of investor relationships. In reality of course it affects all of the operations of a business and its relations with all of its stakeholders – a much more wide-ranging concern than is sometimes appreciated.

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

Corporate governance is therefore currently an important concept the world over. It has gained tremendous importance in recent years. Two of the main reasons for this upsurge in interest are the economic liberalisation and deregulation of industry and business brought about through globalisationand the demand for new corporate ethos and stricter compliance with the law of the land. One more factor that has been responsible for the sudden exposure of the corporate sector to a new concern for corporate governance is that times have changed and there is a demand for greater accountability of companies to their shareholders and customers (Bushman & Smith 2001).

A significant part of the reason for this is due to the developments brought about through globalisation. The phenomenon known as globalisation is a multidimensional process involving economic, politic, social and cultural change. However the most important discussion about globalisation is related to the economic effect it has upon countries and the corporations operating within and across these countries. But this is not really the reason why governance has become so important. The reason is that investors are recognising that good governance leads to better financial performance.

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

There has been much written about globalisation – either positive or negative – and the effects which it is having. One consequence of globalisation though is manifesting itself in the structure and organization of corporations. This is concerned with the harmonisation procedures and structures which will manifest themselves through the emergence of global norms for corporate governance. One factor which is significantly affected by such governance is that of risk assessment and management. Good governance reduces and facilitates the management of risk. This is the focus of this book.

2 The principles of governance

We need to start by looking at the principles of governance and there are 8 principles which underpin every system of good governance:

2.1 Transparency

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

2.2 Rule of law

This is a corollary of the transparency principle. It is apparent that good governance requires a fair framework of rules of operation. Moreover these rules must be enforced impartially, without regard for power relationships. Thus the rights of minorities must be protected[1]. Additionally there must be appeal to an independent body as a means of conflict resolution, and this right of appeal must be known to all stakeholders.[2]

2.3 Participation

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

2.4 Responsiveness

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

2.5 Equity

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

2.6 Efficiency and Effectiveness

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

2.7 Sustainability

This of course requires a long-term perspective for sustainable human development and how to achieve the goals of such development. A growing number of writers over the last quarter of a century have recognised that the activities of an organisation impact upon the external environment, and hence its external stakeholders. These other stakeholders have not just an interest in the activities of the organisation but also a degree of influence over the shaping of those activities. This influence is so significant that it can be argued that the power and influence of these stakeholders is such that it amounts to quasi-ownership of the organisation. Central to this is a concern for the future which has become manifest through the term sustainability.

This term sustainability has become ubiquitous both within the discourse of globalisation and within the discourse of corporate performance. Sustainability is of course a controversial issue and there are many definitions of what is meant by the term. At the broadest definitions sustainability is concerned with the effect which action taken in the present has upon the options available in the future (Crowther 2002). If resources are utilised in the present then they are no longer available for use in the future, and this is of particular concern if the resources are finite in quantity. Thus raw materials of an extractive nature, such as coal, iron or oil, are finite in quantity and once used are not available for future use.

At some point in the future alternatives will be needed to fulfil the functions currently provided by these resources. This may be at some point in the relatively distant future but of more immediate concern is the fact that as resources become depleted then the cost of acquiring the remaining resources tends to increase, and hence the operational costs of organisations tend to increase (Aras & Crowther 2007a).[3] Sustainability therefore implies that society must use no more of a resource than can be regenerated (Aras & Crowther 2007b). This can be defined in terms of the carrying capacity of the ecosystem (Hawken 1993) and described with input – output models of resource consumption.

2.7.1 Sustainability, Sustainable Development and the Triple Bottom Line

One of the developments from the notion of sustainability has been that of Triple Bottom Line Reporting.

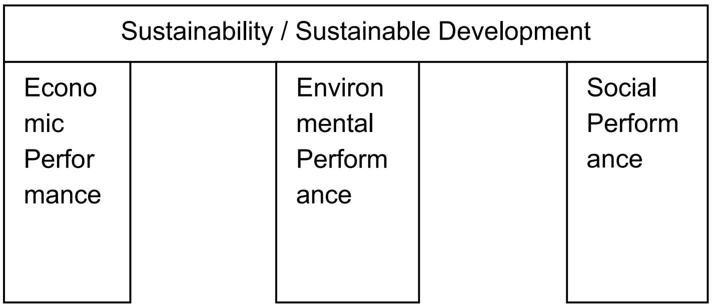

Fig 2.1 The Triple Bottom Line

This is based on an assumption that that there are 3 aspects of performance – economic, social and environmental – and that addressing them is all that is necessary in order to ensure not just sustainability but to also enable sustainable development. Indeed the implicit assumption is one of business as usual – add some information about environmental performance and social performance to conventional financial reporting (the economic performance) and that equates to triple bottom line reporting. And all corporations imply that they have recognised the problems, addressed the issues and thereby ensured sustainable development. This implication is generally accepted without questioning – certainly without any rigorous questioning.

2.8 Accountability

Accountability is concerned with an organisation recognising that its actions affect the external environment, and therefore assuming responsibility for the effects of its actions. This concept therefore implies a recognition that the organisation is part of a wider societal network and has responsibilities to all of that network rather than just to the owners of the organisation. Alongside this acceptance of responsibility therefore must be a recognition that those external stakeholders have the power to affect the way in which those actions of the organisation are taken and a role in deciding whether or not such actions can be justified, and if so at what cost to the organisation and to other stakeholders.

It is inevitable therefore that there is a need for some form of mediation of the different interests in society in order to be able to reach a broad consensus in society on what is in the best interest of the whole community and how this can be achieved. As a general statement we can state that all organisations and institutions are accountable to those who will be affected by decisions or actions, and that this must be recognised within the governance mechanisms.

This accountability must extend to all organisations – both governmental institutions as well those in the private sector and also to civil society organizations – which must all recognise that they are accountable to the public and to their various stakeholders. One significant purpose of this is to ensure that any corruption is eliminated, or at the very least minimised.

3 The Principles of Corporate Governance

3.1 Good Governance

From these general principles have been developed the principles of corporate governance. In practice there are four principles of good corporate governance, which are:

- **Transparency**, which means it needs to be apparent to all what the governance procedures are
- **Accountability**, which means that reporting structures must be clear
- **Responsibility**, which means that someone must be accountable for all parts of the effect – a clear chain of actions required
- **Fairness**, which means that the systems must operate impartially and without prejudice

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

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

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

- Creating sustainable value
- Ways of achieving the firm's goals
- Increasing shareholders' satisfaction
- Efficient and effective management
- Increasing credibility
- Ensuring efficient risk management
- Providing an early warning system against all risk
- Ensuring a responsive and accountable corporation
- Describing the role of a firm's units

- Developing control and internal auditing
- Keeping a balance between economic and social benefit
- Ensuring efficient use of resources
- Controlling performance
- Distributing responsibility fairly
- Producing all necessary information for stakeholders
- Keeping the board sufficiently independent from management
- Facilitating sustainable performance

As can be seen, all of these issues have many ramifications and ensuring their compliance must be thought of as a long term procedure. However firms naturally expect some tangible benefit from good governance. So good governance offers some long term benefit for firms, such as:

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

Although corporate governance is primarily considered to be concerned with how a firm conducts itself in relationship to its investors, increasingly it is being extended to a consideration of how it conducts itself in relation to all of its stakeholders. This is a part of the current concern for greater accountability. Thus governance is increasingly being considered to be related to CSR and the concerns of the two are merging (Aras & Crowther 2009).

3.2 The development of reporting practice

Governance is of course concerned with both the rights of shareholders and, increasingly, the rights of other stakeholders. This extended concern has been paralleled in the developments of regulations concerning financial reporting. At the start of the 20th century it was generally accepted that accounting served the purpose of facilitating the agency relationship between managers and owners of a business, through its reporting function, but that the general public had no right to such information (Murphy 1979).

Thus as far as the UK is concerned, but paralleled in many other countries throughout the world (Crowther 2000), the Companies Act 1906 stated that there was no requirement for companies to produce financial statements, although the Companies (Consolidations) Act 1908 amended this to require the production of a profit & loss account and balance sheet. This was further amended by the Companies Act 1929 which required the production of these, together with a Directors' report and an auditors report for the AGM[4]. Subsequent legislation has extended the reporting requirements of companies to the format seen today as the financial statements and other material.

Such corporate reporting has however been extended in addition to satisfying legislative requirements. Thus the period up to the Second World War[5] saw an increasing use of accounting information for analysis purposes but with an emphasis upon the income statement. This period also saw the extension of the directors report to contain information about the company which was not to be found in the financial statements. This information was however primarily concerning the past actions of the company as corporate reporting as the emphasis in this period remained firmly upon the reporting of past actions as part of the relationship between the ownership and management of the firm.

It is only in the post-war period that this emphasis changed from backward looking to forward looking and from inward looking to outward looking. Gilmore & Willmott (1992) have argued that this was a reflection of the changing nature of such reporting to a focus upon investment decision making and the need to attract investment into the company in this period of expansion. The emphasis remained firmly upon the needs of the company however and only the emphasis had changed from informing existing investors to attracting new investors and so Jordan (1970: 39) was able to claim that:

> 'The purpose of accounting is to communicate economic messages on the results of business decisions and events, insofar as they can be expressed in terms of quantifiable financial data, in such a way as to achieve maximum understanding by the user and correspondence of the message with economic reality.'

At this time the users of such corporate reports have increased so that they are no longer only the shareholders of the company and its managers, but all were however still considered to be a restricted set of the population, having specialist knowledge of and interest in such reporting. The identification of such specialists had however been extended to include both the accounting profession and investment professionals. Thus Cyert & Ijira (1974: 29) were able to claim that:

> 'Financial statements are not just statements reporting on the financial activities and status of a corporation. They are a product of mutual interactions of three parties: corporations, users of financial statements, and the accounting profession.'

while Leach (1975) stated that:

> 'In recent years there have been enormous changes in public interest in and understanding of financial statements. The informed user of accounts today is no longer solely the individual shareholder but equally the trained professional acting for institutional investors and the financial news media.'

Thus there was at this time a general acceptance that corporate reporting should be provided for the knowledgeable professional rather than the individual investor or potential investor, who was assumed to be financially naive (Mauntz & Sharif 1961), and in order to satisfy the needs of these professionals corporate reports became more extensive in content with greater disclosure of financial and other information. This pressure for greater disclosure was not however new, and Mitchell (1906) argued that the accounts produced did not give an adequate basis for shareholder judgement. All that has changed is the perception of who the reporting should be aimed at with a widening of the perceived intended audience from managers and shareholders to include other professionals.

There was at this time little questioning of the assumed knowledge that the financial information is the most important part of the corporate report. The importance of the financial information contained in the reports has changed however and Lee & Tweedie (1977) claimed that the most important financial information contained in the report was details concerning profits, earnings and dividends. They equally claimed that the economic prospects of the firm are the most important information contained in the report (Lee & Tweedie 1975) but were dismissive of the private shareholder in recording (Lee & Tweedie 1977) that the majority read the chairman's report but nothing else.

This focus upon the development of the financial reporting aspects of corporate reporting of course ignores the development of the semiotic of such reporting and the changing nature of this semiotic. This lack of recognition is despite the acceptance that such reporting had changed over time to become more forward looking, to include more non-financial information including the chairman's report, and to become used by a wider range of people.

It has been argued (Crowther 2002; Crowther, Carter & Cooper 2006) that this image creation role of corporate reporting is the most important use of such reporting and the prime vehicle for developing an understanding of such reporting and the changed nature of the reporting itself. Indeed the function of the reporting is to aid social construction of corporate activity in a way which is interpreted positively, regardless of actual performance.

The most recent stage in the development of reporting is epitomised by the most dramatic changes in corporate reporting. No longer is the firm seeking to communicate internally – to members or potential members – but rather the focus is upon the external environment. Indeed no longer do results matter, although still contained in the report but relegated to semi-obscurity, and it is only prospects that matter. Thus the report now becomes predominantly forward looking and, perhaps more significantly, the forward orientation is not upon the economic prospects of the firm but upon the prospects for the shareholder community in terms of rewards – both dividends and share price increases.

Additionally the report now acknowledges the rest of the stakeholder community and seeks to demonstrate corporate citizenship by commenting upon relationship with, and benefits accruing to, employees, society, customers and the local community. Indeed the report has tended to become not a communication medium but rather a mechanism for self promotion. Thus the actual results of the firms past performance no longer matter but rather the image of the firm is what matters and the production of the report is the event itself, rather than merely a communication mechanism. And of course the availability of this reporting has increased dramatically as all companies[6] now show their reports via the Internet as well as via paper, thereby making them potentially accessible to everyone.

The development of corporate governance has to a large extent mirrored this development of financial reporting. Originally corporate governance was considered to be simply how a firm conducted its meetings. This was extended to including the management of relations with investors and potential investors. More recently it has been extended again to deal with relations with all stakeholders as well as to recognise the reality of globalisation. Thus corporate governance is all-encompassing for a firm.

4 Developing a framework for corporate governance

4.1 Introduction

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

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

4.2 Models of Governance

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

However there are important differences between the recent approach to governance issues taken in the USA and what has happened in the UK. In the USA a corporation is governed by a board of directors, which has the power to choose an executive officer, usually known as the chief executive officer (CEO). The CEO has broad power to manage the corporation on a daily basis, but needs to get board approval for certain major actions, such as hiring his/her immediate subordinates, raising money, acquiring another company, major capital expansions, or other expensive projects. Other duties of the board may include policy setting, decision making, monitoring management's performance, or corporate control.

The board of directors is nominally selected by and responsible to the shareholders, but the Articles of Association for many companies make it difficult for all but the largest shareholders to have any influence over the makeup of the board. Normally individual shareholders are not offered a choice of board nominees among which to choose, but are merely asked to rubberstamp the nominees of the sitting board. Perverse incentives have pervaded many corporate boards in the developed world, with board members beholden to the chief executive whose actions they are intended to oversee. Frequently, members of the boards of directors are CEOs of other corporations – in interlocking relationships, which many people see as posing a potential conflict of interest.

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

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

Publicly listed companies in the UK have to either apply those principles or, if they choose not to, to explain in a designated part of their annual reports why they decided not to do so. The monitoring of those explanations is left to shareholders themselves. The basic idea of the Code is that one size does not fit all in matters of corporate governance and that instead of a statutory regime like the Sarbanes-Oxley Act in the U.S., it is best to leave some flexibility to companies so that they can make choices most adapted to their circumstances. If they have good reasons to deviate from the sound rule, they should be able to convincingly explain those to their shareholders.

A form of the code has been in existence since 1992 and has had drastic effects on the way firms are governed in the UK. A recent study shows that in 1993, about 10% of the FTSE 350 companies were fully compliant with all dimensions of the code while by 2003 more than 60% were fully compliant. The same success was not achieved when looking at the explanation part for non compliant companies. Many deviations are simply not explained and a large majority of explanations fail to identify specific circumstances justifying those deviations.

Still, the overall view is that the UK's system works fairly well and in fact is often considered to be a benchmark, and therefore followed by a number of other countries. Nevertheless it still shows that there is more to be done to develop a global framework of corporate governance.

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

Corporate governance principles and codes have been developed in different countries and have been issued by stock exchanges, corporations, institutional investors, or associations (institutes) of directors and managers with the support of governments and international organizations. As a rule, compliance with these governance recommendations is not mandated by law, although the codes which are linked to stock exchange listing requirements[7] will tend to have a coercive effect.

Thus, for example, companies quoted on the London and Toronto Stock Exchanges formally need not follow the recommendations of their respective national codes, but they must disclose whether they follow the recommendations in those documents and, where not, they should provide explanations concerning divergent practices. Such disclosure requirements exert a significant pressure on listed companies for compliance.

In its 'Global Investor Opinion Survey' of over 200 institutional investors first undertaken in 2000 (and updated in 2002), McKinsey found that 80% of the respondents would pay a premium for well-governed companies. They defined a well-governed company as one that had mostly outside directors, who had no management ties, undertook formal evaluation of its directors, and was responsive to investors' requests for information on governance issues.

The size of the premium varied by market, from 11% for Canadian companies to around 40% for companies where the regulatory regime was least certain (eg those in Morocco, Egypt or Russia).

It has been found that the size of the premium varies by market – from around 11% in well regulated markets such as Canada to over 40% where the extent of regulation is much less certain, such as in Morocco, Egypt or Russia.

Other studies have similarly linked broad perceptions of the quality of companies to superior share price performance. On the other hand, research into the relationship between specific corporate governance controls and the financial performance of companies has had very mixed results.

4.3 Governance systems and CSR

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

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

4.3.1 The Anglo American model of governance

The Anglo American model of governance is of course fairly familiar to all readers of this book. It is founded on rules which must be codified and can therefore be subject to a standard interpretation by the appropriate adjudicating body. It has a tendency to be hierarchical and therefore imposed from above; and along with this imposition is an assumption of its efficacy and a lack therefore of considerations of alternatives. In this model therefore the issues of governance, politics and power become inseparably intertwined.

The abuses which have been revealed within this system of governance[8] have exposed problems with the lack of separation of politics from governance. This has led to the suggestion that there should be a clear distinction between the two. The argument is that politics is concerned with the processes by which a group of people, with possibly divergent and contradictory opinions can reach a collective decision which is generally regarded as binding on the group, and therefore enforced as common policy.

Governance, on the other hand, is concerned with the processes and administrative elements of governing rather than its antagonistic ones (Solomon 2007). This argument of course makes the assumption that it is actually possible to make the separation between politics and administration. For example both the UK and the USA have governance procedures to make this separation effective for their national governments – and different procedures in each country – but in both countries the division is continually blurred in practice. Many would argue, and we concur, that the division is not possible in practice because the third factor – that of power – is ignored whereas this is more important.

Indeed it is our argument that it is the operation of this power in practice that brings about many of the governance problems that exist in practice. Part of our argument is that theories and systems of governance assume that power relationships, while not necessarily equal, are not too asymmetric. If the relationship is too asymmetric then the safeguards in a governance system do not operate satisfactorily whereas one of the features of globalisation is an increase in such power asymmetries. We will return to this later.

As we have already identified, the Anglo American model is hierarchical but other forms of governance are allowed and even encouraged to operate within this framework. Thus the market form features prominently in the Anglo American model while the network and consensual forms can also be found. It is therefore apparent that it is not the form of governance which epitomises the Anglo American model; rather it is the dependence on rules and adjudication which distinguishes this system of governance.

4.3.2 The Continental model of governance

The Continental model of governance tends to be less codified than the Anglo American model and finds less need for procedures for adjudication. This is because it is founded in the context of the family and the local community. In some respects therefore it is the opposite of the Anglo American model, being based on a bottom up philosophy rather than a hierarchical top down approach. Thus this model is based on the fact that extended families are associated with all other family members and therefore feel obligated.

And older members of the family are deemed to have more wisdom and therefore assume a leadership role because of the respect accorded them by other family members. As a consequence there is no real need for formal codification of governance procedures and the system of adjudication does not need to be formalised – it works very satisfactorily on an informal basis. Moreover this model is extended from the family to the local community and works on the same basis. An extension of this model of governance is the Network Governance model.

The Network form of governance

In many ways the network form of governance is based on this Latin model, insofar as it is predicated in informal relationships of mutual interest, and without the need for codification: this need is not required because of the interest of all parties in maintaining the working relationships which exist. Thus tradition can be said to play a part in this model of governance – trust based on tradition because it has worked in the past and can be expected to continue working into the future.

The network form however is based on a lack of significant power inequalities whereas the Latin model definitely does have a hierarchy and power is distributed unequally. The power if distributed according to age however and therefore it is acceptable to everyone because they know that they will automatically rise up the hierarchy – thereby acquiring power – as they age. The process is therefore inevitable and deemed to be acceptably fair.

5 Globalisation and corporate governance

5.1 The Modern World

Two features describe the modern world – globalisation and the free market. It is widely accepted – almost unquestioningly – that free markets will lead to greater economic growth and that we will all benefit from this economic growth. All around the world, people – especially politicians and business leaders – are arguing that restrictions upon world economic activity caused by the regulation of markets is bad for our well-being. And in one country after another, for one market after another, governments are capitulating and relaxing their regulations to allow complete freedom of economic activity. So the world is rapidly becoming a global market place for global corporations, increasingly unfettered by regulation.

The regulatory regime of accounting has been increasingly changed over time to serve the interests of businesses rather than their owners or society. Thus no longer is it expected that the accounting of a business should be undertaken conservatively by recognising potential future liabilities while at the same time not recognising future profit. Instead profit can be brought forward into the accounts before it has been earned while liabilities (such as the replacement of an aging electricity distribution network) can be ignored if they reduce current profitability. A study of the changes made in accounting standards over the years shows a gradual relaxation of this requirement for conservatism in accounting as these standards have been changed to allow firms to show increased profits in the present. This of course makes the need for strong governance procedures even more paramount.

Every time society faces a new problem or threat then a new legislative process of some sort is introduced which tries to protect that society from a future reoccurrence (Romano 2004). Recently we have seen a wide range of problems with corporate behaviour, which has arguably led to prominence being given to corporate social responsibility (see for example Boele, Fabig & Wheeler 2001, Aras & Crowther 2007a). Part of this effect is to recognise the concerns of all stakeholders to an organisation, and this has been researched by many people (for example Johnson & Greening 1999; Knox & Maklan 2004) with inconclusive findings. Accordingly therefore corporations, with their increased level of responsibility and accountability to their stakeholders, have felt that there is a need to develop a code for corporate governance so as to guide them towards appropriate stakeholder relations.

A great deal of concern has been expressed all over the world about shortcomings in the systems of corporate governance in operation: Britain, Australia, most other Anglo-American and English speaking countries, and many other countries, have a similar system of governance. Conversely Germany is a good example of where the distance between ownership and control is much less than in the United States, while Japan's system of corporate governance is in some ways in between Germany and the United States, and in other ways different from both (Shleifer & Vishny 1997).

By contrast, in India the corporate governance system in the public sector may be characterized as a transient system, with the key players (viz. politicians, bureaucrats, and managers) taking a myopic view of the system of governance. Such international comparisons illustrate different approaches to the problem of corporate governance and the problem of ensuring that managers act in their shareholders' interest. Recently of course much attention to this issue has been paid by institutional investors (Cox, Brammer & Millington 2004).

Good governance is of course important in every sphere of the society whether it be the corporate environment or general society or the political environment. Good governance levels can, for example, improve public faith and confidence in the political environment. When the resources are too limited to meet the minimum expectations of the people, it is a good governance level that can help to promote the welfare of society. And of course a concern with governance is at least as prevalent in the corporate world (Durnev & Kim 2005).

Corporate governance can be considered as an environment of trust, ethics, moral values and confidence – as a synergic effort of all the constituents of society – that is the stakeholders, including government; the general public and society; professionals/service providers – and the corporate sector. One of the consequences of a concern with the actions of an organisation, and the consequences of those actions, has been an increasing concern with corporate governance (Hermalin 2005). Corporate governance is therefore a current popular phrase the world over. It has gained tremendous importance in recent years.

Some of the main reasons for this upsurge in interest are the economic liberalisation and deregulation of markets industry and business; the demand for new corporate ethos after the exposures of the recent financial crisis; and and expectation of stricter compliance with the law. One more factor that has been responsible for the greater importance of corporate governance for businesses worldwide is of course the demand for greater accountability of companies to their shareholders and customers.

6 Corporate governance and stakeholders

6.1 Defining a stakeholder

As corporate governance has expanded to include a concern for all stakeholders then we need at this point to consider exactly who or what is a stakeholder. There are several definitions. The most common ones are:

- Those groups without whose support the organization would cease to exist
- Any group or individual who can affect or is affected by the achievement of the organization's objectives
- Any individual or group that has an interest in any decision or activity of an organisation

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

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

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

- Government
- Society at large
- The local community

6.2 Broadening the definition

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

- The utilisation of natural resources as a part of its production processes
- The effects of competition between itself and other organisations in the same market
- The enrichment of a local community through the creation of employment opportunities
- Transformation of the landscape due to raw material extraction or waste product storage

- The distribution of wealth created within the firm to the owners of that firm (via dividends) and the workers of that firm (through wages) and the effect of this upon the welfare of individuals
- Pollution caused by increased volumes of traffic and increased journey times because of those increased volumes of traffic

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

- The environment

And we consider some of the implications of this later in the chapter. As we will see in forthcoming chapters the actions of an organisation can also have a big effect upon future possibilities. It is for this reason that we also add one extra stakeholder:

- The future

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

And it should be noted that the purpose of the corporation have been subject to debate for a considerable period of time.

> "There is no reason to think that shareholders are willing to tolerate an amount of corporate non-profit activity which appreciably reduces either dividends or the market performance of the stock."
>
> **Hetherington 1973**

> "….every large corporation should be thought of as a social enterprise; that is an entity whose existence and decisions can be justified insofar as they serve public or social purposes."
>
> **Dahl 1972**

6.3 Multiple stakeholding

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

We can therefore see that it is often not helpful to consider each stakeholder group in isolation and to separate their objectives. Reality is more complex and often there are conflicting pressures upon people because they belong to different stakeholder groupings.

6.4 The classification of stakeholders

There are two main ways to classify stakeholders:

6.4.1 Internal v external

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

6.4.2 Voluntary v involuntary

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

7 The relationship between governance, social responsibility and business success

7.1 The objectives of investors

Often the more significant the power that corporations – multinational and national – have, and especially some groups of stakeholders in a firm have, the more is spoken about corporate social responsibility (CSR). Thus a concept that was some kind of luxury some years ago, nowadays has reached the top of the public opinion discussion. Some steps taken in the corporation's development, in the environment and in the human values can be the guilty causes of this CSR fashion. If in the beginning firms were small and there was no distinction between ownership and management, then economic development meant that there was a necessity to attract more capital in order therefore to set up bigger enterprises.

Thus, there were owners, who gave the funds, and experts in management, who managed the company and were paid by the owners. Agency Theory establishes this relationship between the principal, the shareholder, and the agent, the manager, bearing in mind that the goals of the shareholders must be got through the management of the agents. But, which is the shareholders' main objective? Obviously to increase the enterprise value through the maximization of profits.

But a company's structure is nowadays more complex than before and there have appeared other people, not owners, directly or indirectly implied in the company's operations – known as stakeholders. This complexity has of course increased the need for governance procedures. Multinational corporations have sometimes even more power than governments in their influence, and stakeholders have gained more power through the media and public opinion in order to require some kind of specific behaviour from companies.

Within this new environment, although explained in a very simple way, the primary objective of the company has become wider. Although generally speaking, the assumption may be that the first goal is to get financial performance in the company, after it the next step will be to comply with other socially responsible policies. That is because to pay attention to social objectives, or to show an orientation towards multiple stakeholders groups, could be considered a luxury, because it must have meant that the other basic company's goal had been met. Nowadays though these are not considered as separate objectives – it is generally accepted that socially responsible behaviour results in increased financial performance.

This argument is the basis of the first assertion about the relationship between CSR, stakeholders, and business success namely that better performance results in greater attention to multiple stakeholders. Conversely it can also be argued that the opposite is true, namely that orientation to multiple stakeholder groups influences performance positively, which means to “attend” to social policies in a better way. Both assertions were made by Greenley and Foxall (1997) and there is evidence to show that both have truth in them. Managing performance can clearly be seen to be a complicated process, with different aspects of that performance to take care of.

This double-side relationship increases the difficulty to try to empirically prove it. Intuitively it seems as if there is a clear relationship between CSR and business success, but although the measurement of business success may be easy, through different economic and financial tools, such as ratios, the measurement of the degree of compliance of a company with social policies is really difficult.

We can have in mind some kind of indicators such as funds donated to charitable objectives, but a company can spend immeasurable quantities of money on charitable questions and have problems in the relationship with labour unions because of bad working conditions, or low wages, for example. In this sense there are, since a long time ago, some companies whose objectives include philanthropic aims. It may be understood as the initial values are such ones, and then the market and the capitalism forces the firm to change them in order to survive in this maelstrom.

Although at the same time the double sided relationship operates, because people who are socially concerned bear in mind these basic aims and the image of the company is improved, which has got a direct relationship with its the economic performance. This example may be only one speaking about the market inefficiencies[9] and the trend to acquire human values and ethics that must be forgotten when we are surrounded by this society and the market.

7.2 Governance and performance

The relationship between good governance and business performance is however clearer. As we stated in chapter 1, investors are increasingly willing to pay a premium for good governance in a business because of the expected improvements in sustainable performance which will, over time, be reflected in future dividend streams. And the relationship between social responsibility and governance is similarly clear (see Aras & Crowther 2007b, 2008). In an attempt to satisfy the necessities of the stakeholders there can appear other conflicts between the interests of the different groups included in the wider concept of stakeholders.

Sometimes due to this conflict of interests and to the specific features of the company, it tries to establish different levels between the stakeholders, paying more attention to those ones that are most powerful, but are there some goals more socially responsible than others? In the end the prioritisation among the hierarchy of objectives will depend on the other goals of the company; it will therefore pay attention to those stakeholders that can threaten the performance of the economic goals.

The difficulties in measuring the social performance of a company are also due to the ownership concept. This is because the concept of corporate social responsibility is really comprehensive. There are companies whose activities are really different but all of them have to bear in mind their social responsibility; this not only applies to companies, but also to people in whatever activity they do. From a politician to a teacher: ethics, code of conducts, human values, friendship with the environment, respect to the minorities (what not should be understood as a dictatorship of the minorities) and so on are values that have to be borne in mind and included in the social responsibility concept.

There is a great deal of diversity in aspects of social performance and how it reflects in financial performance. For one company there might be a focus upon environmental issues and such things as their carbon footprint or aspects of climate change. For another company the focus of attention might be upon human rights in the supply chain. There are also regional differences brought about by different cultures, mores and expectations in different countries. Social performance is always against conflicting priorities and not as straightforward as financial performance.

These social problems cannot be isolated because they have got an important relationship with the degree of development of the country, so in the end it is the economy that pushes the world. Capitalism allows the differences between people, but what is not so fair is that these differences are not only due to your effort or work but are also due to having taken advantage of someone else's effort. And this can be the case with multinational corporations, which sometimes abuse of their power, closing factories in developed countries and moving them to developing countries because the wages are lower, or for example, because the security and health conditions are not so strict and so cheaper to maintain for the company. And then the same companies obtain big amounts of profits to expend in philanthropic ways.

Development conditions of regions can determine the relationship between governance and business success; if it is allowed for example in some developing countries to damage the environment or there are no appropriate labour unions and so on then this can happen. Because of lack of requirements or government's attention, then global players use these facilities to obtain a better economic performance although they can be aware of their damaging policies. But not only the degree of development has to do with governance and with social responsibility, countries or regions are also deeply associated with human values through education and culture.

The values are so deep inside us that even it is said that people from different regions of the world who have shared the same education, for example, ethics courses at the university, do not share the same human values, because they are affected by their origins and upbringing. This is perhaps a reason why it might be thought that the inclusion of ethics courses at the university degrees is useless because finally people will go on thinking what they thought at the beginning, depending on the values of their original culture. But everything is not so simple, because there have been many demonstrations of situations where different values have been imported from one culture to another and accepted as their own values without any problem. So, it shows that the questions related to CSR are complicated and not so simple as they can seem at a first glance. Indeed the recent problems with firms behaviour exhibited during the crisis have raised the importance of ethics and ethics education.

The complexity of the ethics discussion can be argued as a disadvantage to take into account when speaking about the creation of global standards for the socially responsible behaviour of companies: there are so many different cases that to establish a general regulation may be really difficult. But at the same time this diversity can be argued to require this regulation, because there have been different initiatives, most of them private, and they have added diversity to the previous one and the subject requires a common effort to try to tackle the problem of its standards and principles.

The latest financial scandals have proved once again that it is not enough to manage with a country's own codes or human values. We have seen that it is necessary to reach an agreement to establish a homogeneous regulation at least at the level of global players, multinational corporations that play globally. The markets are global and governance procedures must be also global to manage in such an environment. Thus globalisation has many far reaching effects such as determining the operating of markets and also the creation of opportunities for misbehaviour. Good corporate governance procedures can overcome this and lead to safer investment and better performance. This is because good governance procedures reduce risk.

8 Risk management and Governance

8.1 Attitudes to risk

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

8.1.1 Risk seeking

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

8.1.2 Risk averse

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

8.1.3 Risk neutral

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

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

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

8.2 Managing risk

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

- Risk assessment
- Risk analysis
- Risk management

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

8.2.1 Risk assessment

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

8.2.2 Risk analysis

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

8.2.3 Risk management

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

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

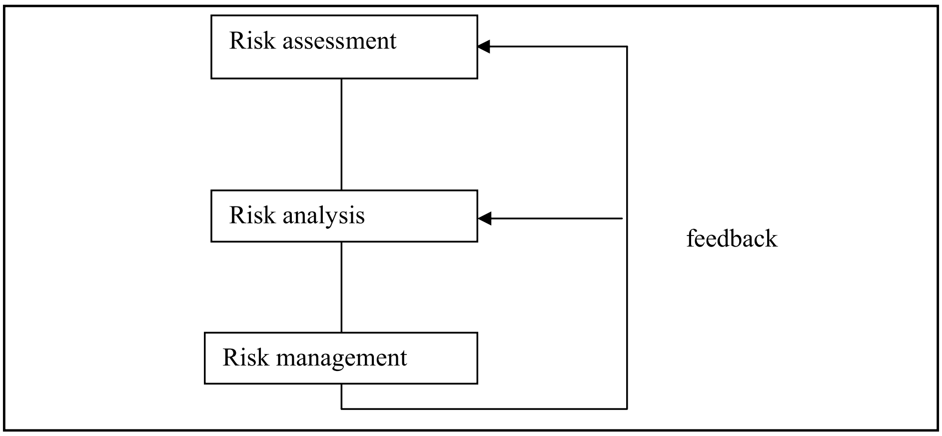

Fig 8.1 Steps in the treatment of Risk

8.3 Risk Management Strategies

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

8.3.1 Risk avoidance

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

8.3.2 Risk reduction

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

8.3.3 Risk protection

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

8.3.4 Risk managing

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

8.3.5 Risk transfer

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

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

8.4 Risk probability profiles

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

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

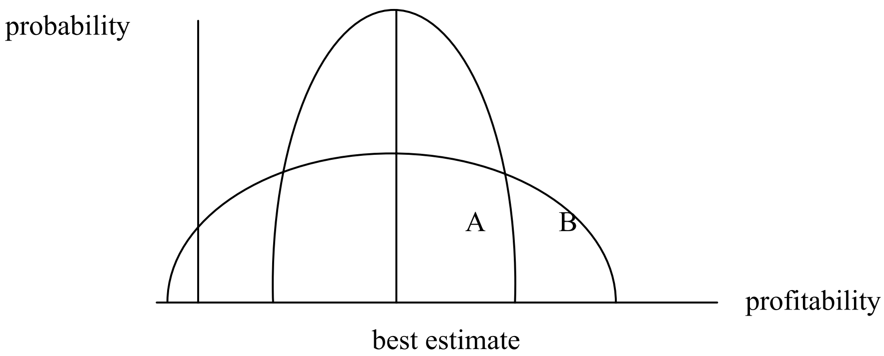

Fig 8.2 Profitability distribution profiles

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

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

8.5 A Typology of risk

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

8.5.1 Global risk

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

8.5.2 Environmental risk

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

8.5.3 Social risk

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

8.5.4 Cultural risk

Much has been written[10] about the relationship between a firm and its employees, which is often negative in nature. This relationship is a source of risk which is particularly significant when the relationship breaks down and litigation or industrial action ensues.

8.5.5 Financial risk

All corporate activity has financial implications. Indeed the nature of a corporation requires the undertaking of financial risk and the acceptance of the consequences. Ideally these will result in financial rewards which are commensurate with the level of risk[11] undertaken but sometimes small rewards lead to a high level of exposure to risk[12]. Here we will mention that good governance is one way to prevent, or at least minimise the possible consequences of this kind of risk.

8.5.6 Long term/short term risk

Often consequences of corporate activity become manifest in the long term and all decisions are subject to both long as well as short term risks. This is of particular significance as some of the long term risks might not be apparent[13] when decisions are taken and action is commenced. Some risk therefore might exist which cannot even be recognised.

8.5.7 Stakeholder/shareholder

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

8.5.8 Technical risk

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

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

9 Risk analysis: Calculating the cost of capital

9.1 Components of the cost of capital

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

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

- the cost of share capital
- the cost of debt

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

For example:

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

The WACC of the company therefore is

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

$$= 7\%$$

Of course the actual calculation of the cost of capital is considerably more complex than this and the managers of many companies spend considerable periods of time in trying to arrive at an accurate calculation of the cost of capital of the company. This is because so many strategic decisions for the company depend upon the NPV[14] calculations, and these in turn depend upon a cost of capital being applied. Different costs of capital will result in different NPV calculations, and therefore different decisions being made. Thus the calculation of the cost of capital is a crucial part of decision making.

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

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

9.2 Systematic risk

The CAPM divides a shares' risk into two parts: systematic and unsystematic. Systematic risk refers to the extent to which share returns vary when the returns on the market as a whole change; it is measured by beta[15]. A share with a beta of 1 tends to rise by 10% for a 10% rise in the market index; a share with a beta of 2 tends to rise by 20% when the returns to the market rise by 10%. In other words shares of companies with higher betas are more volatile.

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

9.3 Unsystematic risk

Unsystematic risk is that portion of total risk which is unique to a firm (or possibly an industry); examples include the quality of management, equipment failure, or new inventions. Because this type of risk is specific to the firm it is possible to reduce the variability of an investors' returns by choosing not to place all funds in one company. That is, the investor diversifies with the expectation that if one or two shares in the portfolio are doing badly this is compensated for by the good performance of others. In a fully diversified[16] portfolio unsystematic risks cancel each other out.

This can be illustrated in figure 9.1 where the amount of unsystematic risk reduces as the number of individual types of share in the portfolio increases:

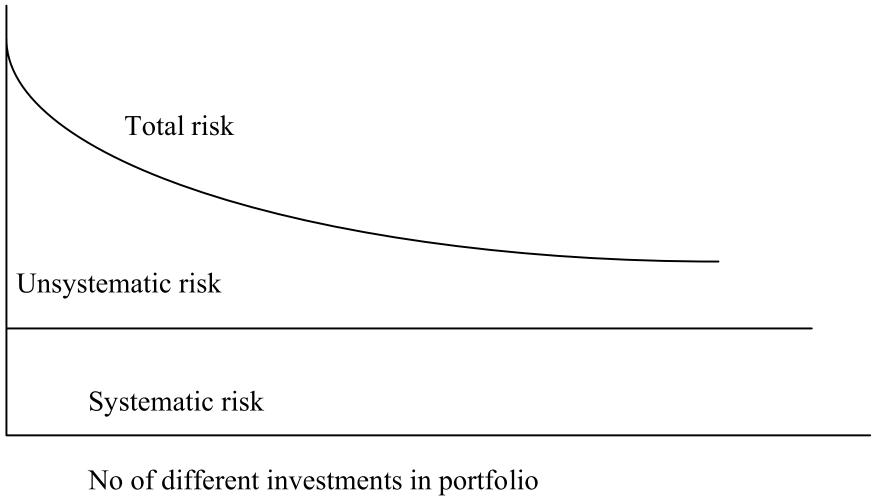

Figure 9.1 Risk and Diversification

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

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

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

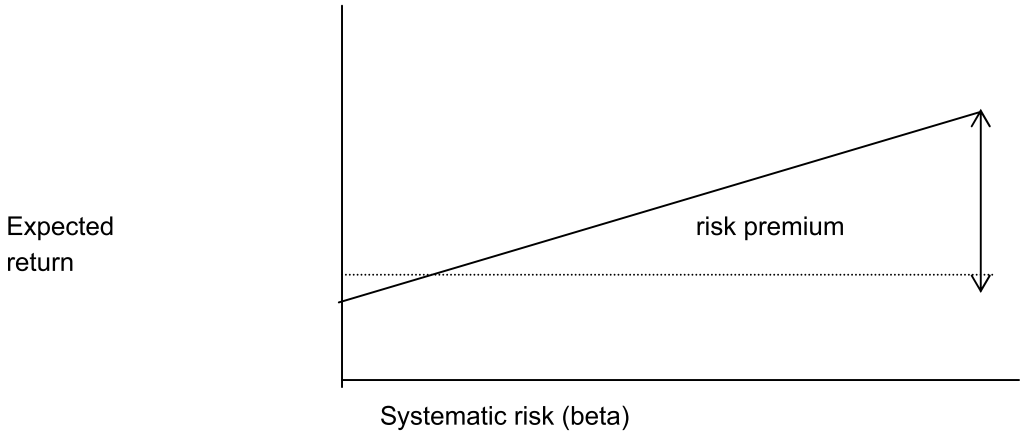

Figure 9.2 The risk premium calculation

9.4 The Capital Asset Pricing model

9.4.1 Beta Values

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

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

Examples of some of these are shown in Table 9.1 below.

Company	Beta
Barclays	1.35
Body Shop	0.47
Boots	0.96
BAT	0.89
British Petroleum	0.95
BTR	1.27
Cadbury Schweppes	0.85
GKN	1.23
Hanson	1.01
Gen. Elec.	1.21
Gen. Motors	0.73
Heinz H.J.	0.72
ITT	1.34
Kellogg	0.71
Wal-Mart Stores	1.14

Table 9.1 1 Beta values.
Source: Datastream

It should be noted that these beta values will change over time for any company and so these shown are merely illustrative of the range of values for a variety of companies at a particular point in time.

Let us look at a calculation of the cost of capital using the example we used above, but this time being more precise in our calculation.

Cost of Equity using CAPM
Let us assume the following:

beta = 1.0
market risk premium = 6%
risk free rate = 8%

The cost of equity therefore is as follows:
r = 8% + 1 x 6% = 14%

Cost of Debt

Let us assume cost of borrowing = 9% before tax, ie slightly above risk free rate.
Interest is tax deductible, so the company only really pays 9% x (1 – t)
Let us assume that t (the tax rate) = 25%
Effective cost of debt after tax = 6.75%

Cost of capital calculation

This time the calculation of the cost of capital is:

$$WACC = \frac{1{,}000{,}000 \times 6.75 + 500{,}000 \times 14\%}{1{,}500{,}000}$$

$$= 9.17\%$$

9.5 The cost of capital for a business

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

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

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

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

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

9.6 Regulation and its implications

The disclosure of the actions of the firm in terms of their impact upon the external environment is essentially voluntary in nature – but this does not necessarily mean that the actions themselves are always voluntary. Nor does it mean that all such disclosure is necessarily voluntary.

The regulatory regime which operates in any particular country means that certain actions must be taken by firms which affect their influence upon the external environment. Equally certain actions are prevented from being taken. These actions and prohibitions are controlled by means of regulation imposed by the government of that country – both the national government and local government.

For example those regulations probably govern the type of discharges which can be made by organisations, particularly when these are considered to cause pollution. Such regulations govern the way in which waste must be disposed of and the level of pollutants allowed for discharges into rivers, as well as restricting the amount of water which can be extracted from rivers.

The regulatory regime which operates in every country is continuing to change and become more restrictive as far as the actions of an organisation and its relationship with the external environment are concerned[17]. It seems reasonable to expect these changes to continue into the future and concern for the environmental impact of the activities of organisations to increase. These regulations tend to require reporting of the activities of organisations and such reporting also involves an accounting connotation.

This accounting need is both to satisfy regulatory requirements but also to meet the internal needs of the organisation. This is because the managers of that organisation, in both controlling current operations and in planning future business activities, must have accounting data to help manage the organisational activities in this respect. The growth of environmental data, as part of the management information systems of organisations, therefore can be seen to be, at least in part, driven by the needs of society at large. In this way it is reflected in the regulations imposed upon the activities of organisations.

9.7 Environmental Impact Reporting

As the extent of regulation of such activities can be expected to increase in the future therefore the more forward looking and proactive organisations might be expected to have a tendency to extend their environmental impact reporting in anticipation of future regulation, rather than merely reacting to existing regulation. Certainly there is evidence that the best companies act well before any regulatory changes and that such changes are merely a reflection of best practice which is determined through the activities of the best companies.

It should not be thought however that the increase in stature and prominence accorded to environmental accounting and reporting among organisations is driven entirely by present and anticipated regulations. To a large extent the external reporting of such environmental impact is not determined by regulations – these merely require reporting to the appropriate regulatory body. Nor can it be argued that the increasing multinational aspect of organisational activity, and the consequent need to satisfy regulatory regimes from different countries, has alone driven the increased importance of environmental accounting.

Organisations which choose to report externally upon the impact of their activities on the external environment tend to do so voluntarily. In doing so they expect to derive some benefit from this kind of accounting and reporting. The kind of benefits which organisations can expect to accrue through this kind of disclosure are outside the scope of this book. At this point therefore we should remember the influence of stakeholders upon the organisation and it can be suggested that increased disclosure of the activities of the organisation is a reflection of the growing power and influence of stakeholders, without any form of legal ownership, and the recognition of this influence by the organisation and its managers.

When the UK government, for example, initiated its process of the privatisation of nationally owned utilities it was felt necessary to compensate for the inadequacy of the market mechanism for mediating between the conflicting needs of the stakeholders to these industries. Thus the concept of regulation was devised, with appropriate bodies formed, to compensate for the imperfections of competition in the quasi-markets which came into being.

One of the functions of the regulators created in this manner was to control the prices charged by these privatised utilities in order to ensure that the benefits and efficiencies gains vaunted as a benefit of privatisation were shared between shareholders and other stakeholders, principally the customers. Thus the regulators were to act as the very visible, "invisible" hand of the market. The main mechanism for this has been achieved by means of a periodic review of pricing policy. For other industries however the effects of regulation vary in extent but in general terms can be stated to be increasing over time and this increase can be expected to continue into the future.

10 Summary

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

It is equally possible to state that a firm which has a more complete understanding of the relationship between social responsibility, sustainability and corporate governance will address these issues more completely. By implication a more complete understanding of the inter-relationships will lead to better corporate governance, and therefore to better economic performance.

The other tentative conclusion is concerned with the extent of disclosure manifest through the reporting of such things as corporate governance and corporate social responsibility, and is more in the nature of a prognosis. Crowther (2000) traces an archaeology of corporate reporting which shows that, over time, the amount of information provided – first to shareholders, then to potential investors (Gilmore & Willmott 1992), then to other stakeholders – has gradually increased throughout the last century, as firms recognised the benefit in providing increased disclosure.

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

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

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12 Suggestions for further reading

12.1 Articles:

Aras G & Crowther D (2008); Governance and sustainability: An investigation into the relationship between corporate governance and corporate sustainability; *Management Decision* 46 (3), 433–448.

Aras G & Crowther D (2009); Corporate Governance and Corporate Social Responsibility in context; in G Aras & D Crowther (eds), *Global Perspectives on Corporate Governance and Corporate Social Responsibility*; Farnham; Gower; 2009; pp. 1–41.

12.2 Books:

Aras G & Crowther D; Culture and Corporate Governance; SRRNet; 2008
Aras G & Crowther D; The Durable Corporation: Strategies for sustainable development; Gower; 2009
Aras G & Crowther D; Global Perspectives on Corporate Governance and CSR; Gower; 2009
Aras G & Crowther D; Governance and Social Responsibility; Macmillan; 2011
Clarke T; Theories of Corporate Governance; Routledge; 2004
Clarke T; International Corporate Governance: a Comparative Approach; Routledge; 2007
Monks RAG & Minow N; Corporate Governance; Blackwell 2007
Solomon J; Corporate Governance and Accountability; John Wiley; 2007

Endnotes

1. This would imply of course the protection of human rights but could be taken also to imply concern for the environment and its protection.
2. This can be to national courts, trade associations, supra-national courts such as the European Court of Human Rights, or to an organisation such as the United Nations. Whatever the body it needs to be appropriate and not just impartial but also seen to be impartial to all concerned in order to maintain the creditability to adjudicate disputes.
3. Similarly once an animal or plant species becomes extinct then the benefits of that species to the environment can no longer be accrued. In view of the fact that many pharmaceuticals are currently being developed from plant species still being discovered this may be significant for the future.
4. Annual General Meeting
5. From 1939–1945.
6. It is accepted that not all companies throughout the world yet do this but the number of companies which do not report via the Internet is shrinking rapidly. Moreover it is a requirement in an increasing number of countries.
7. Such as, for example, the UK Combined Code referred to earlier.
8. For example in the UK there is at present (2010) an ongoing criminal investigation into the activities of some former members of parliament and the fraudulent claims for expenses. This investigation has already led to a significant number of resignation including in the newly formed coalition government. This represents a failure in governance which requires both rules and their enforcement. Similarly many people would, as far as the USA is concerned, blame failures in the governance system generally for the debacle of the Enron affair. These two countries are of course the principle exponents of the Anglo American model of governance.
9. See Baumol & Batey (1993).
10. See for example Davila Gomez & Crowther (2007).
11. This is of course the basis upon which financial management is based.
12. Consider for example the financial consequences for Barings Bank of their focus upon short term financial success. Nick Leeson was able to gamble so much that he destroyed the bank.
13. The consequences of the use of asbestos, for example, were not known about in the 1960s when this material was considered beneficial for commercial use.
14. NPV = net present value. It is a mechanism for translating future costs and revenues to present day value. Its calculation is outside the scope of this book.
15. See section 9.4.1 for an explanation of beta values.
16. Diversification in this context means to increase the number of shares in different companies which are held
17. In other words the extent of regulation in this area has increased in recent years and is continuing to increase.