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The Financial Crisis, Investor Activists and Corporate Strategy: Will this Mean Shareholders in the Boardroom?

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Abstract

The concept of stakeholder engagement is gaining increasing attention in the mainstream media and may feature as part of a corporation's strategy for corporate social responsibility. Not only are boards considering how they might engage with key stakeholders, but stakeholders are also pursuing greater participation in the strategic decisions of companies in which they invest. While this is an emerging concept in companies governed by unitary boards, as in North America, the issue of stakeholder engagement in various forms is also entering debate in other countries around the world. In general, however, the idea of shareholder or stakeholder representation on the boards of most UK and Commonwealth companies is anathema. Forces now influencing the development of strategies for stakeholder engagement and the rise of active investors include changing corporate governance rules which give investors more power in the election of directors, the increasing role of pension plans and hedge fund investment groups which have produced investors who keep a close eye on company performance and value, and a sluggish or turbulent stock market as a result of the financial crisis initiated by the credit crunch in the sub-prime mortgage markets. In this paper the phenomenon of stakeholder representation is examined and results of a recent survey conducted among a large sample of New Zealand directors are presented. The findings suggest that these traditionally-oriented boards are increasingly inwardly focused and are without an agenda for building and managing shareholder and stakeholder relations. Accordingly, such boards are unlikely to regard stakeholder engagement as a serious strategic issue and are thus also likely to miss significant opportunities in the changed business environment to benefit from stakeholder support.

1.0 Introduction

At this point in the fall-out from the Wall Street-US financial melt-down, surprisingly little debate has ensued over the efficacy of corporate governance in the banking sector debacle. A review of the *Wall Street Journal* over recent months, for instance, shows an absence of direct reference to the boards of directors of the failed banking "Titans". Indirect reference can be implied from such investigations by the US Securities and Exchange Commission (SEC), the Federal Bureau of Investigation (FBI), state attorneys' offices and other federal agencies in opening preliminary enquiries into Fannie Mae, Freddie Mac, Lehman and AIG over whether fraud is implicated in their demise[1]. Criticism in a report on the SEC by the Inspector General over missing "numerous potential red flags" leading up to the "shotgun sale" of Bear Stearns also points to an oversight in failing to rein in the investment bank's aggressive risk taking[2]. Similar failures by the SEC have emerged over its supposed neglect to properly investigate allegations of fraud regarding the massive "Ponzi Scheme" in the most recent Madoff[3] scandal that represents the worst single financial collapse in US history. Moreover the US has not been alone in its share of corporate failures and scandals since the onset of the current financial crisis, with other corporate crises emerging across Europe and elsewhere. However, the targets of such investigations are primarily the chief executive officers (CEOs) rather than the boards of directors of these companies. At best the business media has reported changes in board composition along with significant discussion of the departures of CEOs of companies such as the Royal Bank of Scotland[4] and Bank of America[5].

While the present financial crisis is monumental, even potentially cataclysmic in scale, complex in its contributing factors and global in its economic impact, at the centre of the systemic failure are the banking and financial institutions that have fallen victim to the current wave of corporate collapses initiated by the sub-prime credit crunch that began in the US and then spread worldwide almost two years prior to these events. The main response from the financial and equity markets has been the inevitable calls for reform and tighter regulation, with greater oversight roles for central banks, including the possibility of a much strengthened International Monetary Fund (IMF) as a global central bank and financial regulator[6]. Such steps are perhaps necessary, but absent so far is any fundamental questioning of the responsibility of the boards of directors and executives embroiled in the current financial debacle and their role in the failures of their companies.

Similar events in recent history that have shaken the global financial markets include the 1997 Asian Financial Crisis and the corporate scandals associated with Enron, WorldCom, Tyco, Parmalat and others in the early years of the present decade. Both sets of events have been marked unequivocally as failures in corporate governance and each has led to numerous governance reforms and efforts worldwide to make corporations and boards

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[1] *Wall Street Journal* 30/09/08, p.19, and 07/10/08, p. 4.
[2] *Wall Street Journal* 29/09/08, p.19.
[3] *Financial Times*, 27/01/09, p. 7.
[4] *Financial Times*, 07/02/09. RBS Slims down 16-strong board in break from past. http://www.ft.com/cms/s/0/e0ca96a8-f4b9-11dd-8e76-0000779fd2ac.html
[5] *Wall Street Journal* 06-08/02/09, p. 14, John Thain.
[6] As proposed at the Heads of Nations annual meeting of the World Economic Forum, Davos, Switzerland, January 2009. See "UK financial regulator calls for world watchdog". *International Herald Tribune*, 28 January 2008. Retrieved 06.02.09 http://www.iht.com/articles/ap/2009/01/28/business/Davos-Forum-Financial-Regulation.php

more accountable to investors and shareholders. However, the damage resulting from those events had spill-over effects that reached far beyond the investors, with economic consequences for the wider communities and crises of public confidence in the capitalist market system itself. With the present crisis, world heads of governments outside the US are now seriously questioning the Anglo-Saxon model of capitalism and some commentators see an end to the dominance of that system[7]. The potential and actual harm to society, and not just investors, from flow-on effects of such failures has led to the belief that powerful corporations are accountable not only to investor-shareholders but also to society itself, whose citizens also are also stakeholders in the affairs of these companies.

This means that corporate boards increasingly have been expected to pay attention to matters relating to social responsibility and to corporate sustainability. The idea that corporations are accountable not just to shareholders for their economic performance but also to the wider society for the consequences of their decisions and activities runs counter to the narrower shareholder capitalist view articulated by Milton Friedman (1970, pp. 32-33) that "the social responsibility of business is to increase its profits…". Friedman stated that "The responsibility of the corporate executive is to conduct business in accordance with the desires of the owners of the business, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom." He argued further that "there is 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, which is to say, engages in open and free competition without deception or fraud." Friedman's view of responsibility in relation to businesses upholds the notion that the common good is best served when individuals and economic institutions pursue competitive advantage within a *laissez faire* market system. From this perspective the integration of moral judgment within corporate strategy is strongly resisted, because such integration is seen as an inefficient use of resources and ultimately both an illegitimate use of corporate power and an abuse of management's and directors' fiduciary role (Goodpaster and Matthews, 1982; Ingley, 2008).

Friedman's philosophy continues to have currency today but is far from being universally shared, either within the business community or among the broader community (Makower, 2006). Nevertheless, many companies align with Friedman's contention that adopting and practicing "corporate social responsibility", "sustainable business" and "community engagement" is a distraction from their core obligation, which is to act in their shareholders' best interests (Carter & Lorsch 2004, Grayson & Hodges 2004, Healy 2003). On the other hand Makower (2006[8]) argued that while "unfettered markets and exploitation-friendly tax schemes" reward companies for acting in their own interests in the name of economic growth and competitiveness, the "profits-are-everything" philosophy presents a soulless view of the role of business and business leaders in our society.

The revelation of conflicts of interest during the significant corporate crises of recent years, such as those involving Enron and others, clearly revealed the importance of stakeholders other than just the shareholders. Employees, customers, suppliers and local organisations suffered enormous economic losses as a result of managers' seeking to benefit personally

[7] e.g. "Bailout paves new road for capitalism", *Wall Street Journal* 23/09/08, pp. 19-20; "Leaders discuss crisis response", *Wall Street Journal* 23/09/08, p.13.
[8] Online. Available at http://www.worldchanging.com/archives/005373.html

through artificial inflation of short-term returns and sharp increases in the market prices of their shares (Huse, 2007; Child & Rodriguez, 2003). These corporate events have added to the pressures on companies to become more socially responsible. Some forty years after Friedman's provocative statement it can be argued that the "rules of the game" as he proclaimed them to be have changed as deepening concerns over environmental and economic sustainability usher in an era of global market sobriety.

Under the broader concept of corporate social responsibility (CSR) the paper considers the related emerging concepts of corporate stakeholder engagement (CSE) and corporate democracy[9] as a basis for examining board accountability, the need for board-investor engagement to drive the notion of social responsibility in corporate governance, and the rationale that underpins this perspective. The background is thus set for examining the extent to which such a concept is embraced by corporate boards. A brief overview of New Zealand boards provides a context against which a summary of results from our survey of corporate governance in these companies is presented. In particular, the findings from this survey and its precursors highlight the attitudes and practices of New Zealand directors and executives with regard to their obligations to shareholders and other stakeholders, as well as investor perceptions of governance. While progress is being made internationally in companies' willingness to be responsive to stakeholders and to recognise their obligations to wider society as part of their fiduciary duty of care, the results of this research show that meaningful accountability by boards of directors to stakeholders has yet to replace the narrower view of shareholder capitalism which remains the dominant paradigm for corporate governance.

2.0 Corporate Social Responsibility and Stakeholders

The two contrasting views of capitalism referred to in this paper are "shareholder capitalism" and "stakeholder capitalism". While various labels are often attached to the concept of capitalism (such as "financial capitalism", "market capitalism", "corporate capitalism", "social-democratic capitalism", and so on), it is these two types that are the particular focus of this discussion.

The agency perspective has dominated the realm of corporate governance, focusing on single constituents (management and shareholder/owners) with regard to addressing their conflicting interests, in order to bring about improvements to governance practice. Based on microeconomic principles of utility maximisation, it is agency theory that underpins the shareholder model of capitalism, which accentuates shareholder value maximisation as its primary goal. Agency theory addresses the dilemma in bringing the conflicting objectives of individuals into equilibrium and thus provides a foundation for understanding one of the most important relationships in corporate governance (Jensen, 2000). However, a significant weakness lies in its predominant focus on the principal/agent relationship and its central concern with monitoring and control and thus it ignores the wider complexities of corporate life.

[9] Care is required in the use of the term "corporate democracy" since it holds different meanings, as cautioned by Joo (2003, 2006). In this paper the term is used in the sense of a more participative involvement by shareholders and other stakeholders than is currently available through shareholder voting rights. It also is used in the sense of addressing issues of corporate hierarchy and corporate power. However, a more in-depth discussion of this debate is outside the scope of this paper.

Concurrent with the emphasis on maximisation of shareholder value in prescriptions for better corporate governance practice, international groups have championed the other stakeholders with which corporations interact. For example the Organisation for Economic Cooperation and Development (OECD) Principles of Corporate Governance (1999, 2004), endorsed by the World Bank and the IMF as well as prominent institutional investors, stressed the need for equal treatment of all classes of shareholders, and highlighted the significance of other stakeholders such as employees and environmental interest groups (Aguilera, 2005). Stakeholder capitalism represents an emerging model that remains controversial in corporate governance and is based essentially on stakeholder theory which claims that organisations have multilateral pacts with their various stakeholders (Clarke, 2004).

Freeman (1984, p.25) defined a stakeholder as "any group or individual who can affect or is affected by the achievement of the firm's objectives". A vast stakeholder literature has since shown that almost anyone can affect or be affected by an organisation's actions, including persons, groups, organisations, institutions, communities and societies (Mitchell, Agla & Wood, 1997), many of whom have legitimate, that is, moral, legal, and property-based stakeholder claims on managers and the company. The following discussion highlights the contrast between (a) the concept of agency-based shareholder capitalism and the stakeholder perspective of value creation, and (b) market competition and social competition as forces that drive the propensity for corporate social responsibility and stakeholder engagement.

2.1 Theoretical Perspectives

Scholars have increasingly criticised agency theory's primary assumptions, especially with regard to capturing governance as a principal/agent relationship and its implications for the role of the board of directors as the central monitoring mechanism in corporate governance (e.g. Goshal & Moran, 1996; Hirsch, Michaels & Freedman, 1987; Kiel and Nicholson, 2003; Perrow, 1986, Tricker, 1994a). A consensus has emerged in the literature around the need for a multi-theoretical approach to more adequately capture the complexity of corporate governance and the board's role in the modern context than is represented by agency theory. Efforts to develop a unified model of corporate governance based on multiple theoretical perspectives have yet to produce a fully-integrated framework. Stakeholder theory has featured as a more integrative perspective that argues in favour of a wider set of social and economic values that underpin social wealth creation compared with agency theory which promotes financially driven shareholder value creation.

In contrast to the agency perspective, stakeholder theory – a view that incorporates aspects of four theories: agency theory, stewardship theory, resource dependency and the resource-based view of the firm – is a more inclusive approach inasmuch as it takes into greater account the complex character of the corporate social context and the attendant obligation upon corporations to act as socially responsible citizens (Ingley & van der Walt, 2004). The stakeholder perspective begins with the premise that the creation of shareholder wealth is not the sole reason for companies to exist. Stakeholder theory is based on the view that companies and society are interdependent and therefore the corporation serves a broader social purpose than its responsibilities to shareholders, to whom it is primarily but not solely responsible (Donaldson and Preston 1995, Kiel & Nicholson 2003).

The claim that businesses have social responsibilities suggests that they have an obligation to take actions that appear to further some social good beyond their direct interests and beyond that required by law (or at least to minimise or prevent social harm). Such actions may, for example, involve "doing good" by adopting progressive human resource management programmes, developing non-animal testing procedures, or supporting local businesses (Hasnas, 1998; McWilliams & Siegel, 2001). In describing the stakeholder concept of the corporation as a complex web of relationships that extend beyond the traditional shareholder-management relationship, Kiel and Nicholson (2003, p. 31) stated that each company has its own unique set of stakeholder groups. This includes not just the financial claimants but all individuals or groups who can substantially affect the welfare of the firm (Jensen, 2000). According to this perspective boards and managers should take account of stakeholders' interests and produce an outcome that is acceptable to all those likely to be affected by the decisions and actions of the business (Evans & Freeman 1988, Healy 2003, Kiel & Nicholson 2003).

Corporations thus can be seen as organised social systems or collective entities with multiple or pluralistic interests (Aguilera, 2005). Viewed as corporate citizens within this social system, corporations are widely and increasingly expected to respond to pressures not only from shareholders but from a range of other stakeholders such as customers, employees, suppliers, listings and ratings agencies, liability insurers, auditors and government departments, as well as groups in the wider community in which they exist and conduct their business (Selznick, 1992).

The main disadvantage with the stakeholder model, as argued by Kiel and Nicholson (2003), is that stability can lead to conservatism. By concentrating on strengthening ties with stakeholders, companies can become inefficient in the allocation of resources and less adaptive to change[10]. Whatever the merits or otherwise of this reasoning, when compared with the simple goal of shareholder value, stakeholder value is seen as a more elusive goal to pursue (Davies, 1999). Benn and Dunphy (2007) argued that despite claims for the importance of stakeholder engagement in creating sustainable organisations, stakeholder theory has a limited capacity to address the equitable management of risk, that is, how to operationalise a system of governance that simultaneously integrates the concerns of humans and non-humans as stakeholders and addresses economic and environmental goals. Indeed, stakeholder theory is viewed by some "as a vague notion of balancing interests for a substantive corporate objective [whilst] providing no effective standard against which directors or managers can be judged" (Sternberg, 1999, p.21). The practical difficulties in establishing some degree of enforceable accountability to stakeholders, especially employees, are not, however, insurmountable, as experience demonstrates in parts of the European Union such as the Netherlands.

Stakeholder theory has become the central paradigm in CSR (McWilliams & Siegel, 2001) and over the past two decades has progressed from the margins to the mainstream of business management thought and practice. In the CSR debate the concept of Anglo-Saxon shareholder capitalism, which maintains that companies should pursue exclusively the interests of their shareholders, is pitted against the notion of stakeholder capitalism, which recognises that companies are also responsible to their workers and local communities. Those supporting a stakeholder perspective argue that as businesses – and large corporations in particular – are social institutions, they are challenged with balancing

[10] as may be the case in Japan.

economic performance against social accountability (Bosch 1996, Brown Jr. 1996, Davies 1999, Donaldson & Preston 1995, Hawkins 1997, Healy 2003, Kiel & Nicholson 2003, Pomeranz 1998, Shleifer & Vishny 1997). In this debate, the political “left” demands that more rules be applied to companies to make them more responsible, while the “right” counters that governments already delegate too much of their social policy to companies (*The Economist* 12/14/2002, p. 62). Nowhere has this debate surfaced more prominently than in the US Senate’s political embattlement over the passing of the US$700 billion “Bailout Bill” (finally passed through its first stage 03/10/08) amidst deep concerns over moral hazard as an unintended consequence, and the subsequent months of further heated Senate debate over TARP[11] (signed 17/02/09) as part of a centrally funded plan to rescue the US financial market system.

From a practical perspective, all companies have to secure a franchise from society (Clarke 2007, Garratt 1997, Grayson & Hodges 2004, Knoepfel 2001, Kostant 1999, Makower 2006, van der Walt & Ingley 2004). While the franchise, or “licence to operate” (Andriof & Marsden, 2000; Waddock, 2004), comes partly from consumers and other pressure groups in the private sector (Clarke 2007), the most enduring influence on corporate behaviour has been the State with regard to whose interests companies should serve. Indeed, while Roosevelt (US President, 1933-45) believed in corporations, saying that “They are indispensable instruments of our modern civilisation,” he also believed “that they should be supervised and so regulated that they shall act for the interests of the community as a whole” (*The Economist* 12/14/2002, p. 63).

In the late 1980s, more than half of North America’s state legislatures adopted “other constituency” statutes that encourage or mandate[12] directors to consider the interests of all their stakeholders and not just shareholders. At the same time, Anglo-Saxon companies have often willingly taken on social obligations without the prompting of government. For example, companies introduced pensions and health-care benefits well before these contributions became a legislative requirement. While critics such as Friedman (1970) tend to dismiss such voluntary actions as window-dressing, many companies endeavour to behave ethically and do good because they genuinely believe that taking care of their workers and others in society is in the long-term interests of their shareholders[13] (Grayson & Hodges 2004, Makower 2006, Roberts, McNulty & Stiles, 2005, *The Economist* 12/14/2002).

While stakeholder theory and CSR have attracted increasing attention from scholars and researchers, at the same time little clear direction is given on how to make decisions and assess the importance or even the legitimacy of various stakeholder claims (Marens & Wicks, 1995). CSR has evoked from organisations a variety of responses that are often disconnected from their business operations and strategy. Such responses might include, for example, placating pressure groups in a series of short-term defensive reactions (Porter

[11] Troubled Assets Relief Programme.

[12] Connecticut has passed a law requiring them to do this.

[13] E.g. For more than half a century, Hewlett-Packard has argued that profit is not the main point of its business (*The Economist* 12/14/2002). DIY homeware and retail chain B&Q has found ways to improve services to disabled customers and those who shop with them through a network of some 300 partnerships between staff and local disability groups across the UK. Staff competence for this market group has improved as a result, attracting disabled customers as well as increasing employee satisfaction and productivity (Grayson & Hodges 2004).

& Kramer, 2006). Indeed CSR and related concepts such as sustainable development and business ethics remain ambiguous in both theoretical debate and in implementation (Lo & Sheu, 2007; Valor, 2005).

Moreover, stakeholder theory and CSR have not yet been applied widely to boards of directors and there is a much smaller body of literature reflecting the relevance of this concept to corporate governance and the fiduciary role of the board. The notion of corporate engagement, implying a relational board model and a relationship management approach to stakeholders, is not yet a widely accepted facet of board responsibility. There are few empirical findings relating specifically to boards and stakeholder engagement, with little or no guidance for directors on balancing stakeholder claims and even less guidance on incorporating such claims into strategic decisions, especially as each stakeholder may have a different legal, economic and social relationship with a particular business.

2.2 Boards and Corporate Social Responsibility

The notion of CSR and the idea that corporations have obligations beyond their primary responsibility to their shareholders has led to a broadening of the domain of corporate governance (Doh & Guay, 2006; Donaldson & Preston, 1995). Companies practicing good governance are thus expected by the public to demonstrate good corporate citizenship, being accountable not only to shareholders, but also to other stakeholders and to the wider community within which they exist. With the mainstreaming of CSR the concept of the board's fiduciary duty has expanded and today requires different structures for considering social and environmental questions that some boards may be ill-prepared to oversee (as the current wave of collapsed banking institutions and the consequent social as well as economic impacts attest) and which traditionally they have not been required to address (Cramer & Hirschland 2006). As declared of a director's role by *The Economist* (2004), "What was once a comfortable and lucrative sinecure is beginning to look like the job from hell" (cited by Schacter 2005, p. 12).

The focus on interaction with stakeholders indicates a much broader range of responsibilities for boards of directors than the more limited shareholder view. In short, according to the stakeholder perspective, the directors act as trustees, balancing the interests of stakeholders including shareholders for mutual benefit, and thereby help to *sustain* assets rather than merely maximise their value (Healy, 2003). This pluralist approach to board roles and board decision making places the board at the apex of an open interacting system of relationships and resources comprising internal actors (top management, employees), external actors (shareholders and other financial capital providers, customers, suppliers), and the board members (Huse, 2005). According to this relational view the board has a boundary spanning role at the interface between the internal and external actors in the governance system.

2.3 Boards and Stakeholders

In support of this pluralist view of accountability for boards, Roberts, McNulty & Stiles (2005) argued that agency theory is inadequate as a rationale for the governance of the modern corporation, because it assumes the need to find ways to align only the interests of principals (owners) with those of their agents (the managers). Instead, both principals and agents might seek to support other interests such as employee or community well-being. It is therefore useful to contemplate the extent to which, from an agency perspective, the much-emphasised independence of directors from executives (to minimise and control managerial opportunism and offset executive power) as advocated in corporate governance guidelines, aligns with their service role of intermediation among different stakeholders and as advisors to managers (Aguilera, 2005).

Stiles and Taylor's (2001) study of how directors view their roles and responsibilities showed that many took a limited view of the idea of stakeholders. Customers, employees, suppliers, creditors and lenders were seen by directors in this study as comprising the heart of any list of stakeholders because they formed some kind of "contractual" relationship with the company (p.98) and were therefore considered to be primary stakeholders. A secondary tier of stakeholders assigned a lower priority included pressure groups, the media, competitors, the government and the community as a whole. However, the directors in the study were less clear on how stakeholder deliberations were factored into board decision making. There seemed to be no formal process, but if significant stakeholder concerns arose, they were assessed case by case. For these directors, stakeholder concerns would influence strategy formulation only if the board feared a serious adverse effect on any group as a result of a decision such as, for example, closure of a large plant, or possible environmental damage (Stiles & Taylor, 2001).

The problem of addressing outsider interests, however, is compounded for non-executive directors. In reality, non-executive oversight of the activities of the executive and especially the chief executive may not be as firm and critical as official institutional voices demand and the weight of prescription in corporate governance regulations requires. This is due to the board decision-making culture, which weighs differentially insider and outside interactions. Actual board practices appear to be more closely aligned to the needs and demands of internal actors who are generally considered to be the top management team (Huse 2005). Having the same business background, non-executive directors usually subscribe to the same dominant business ideology as the executives. This means that they may intervene reactively in executive decisions and therefore be less effective as a check on management hegemony. However, Hill (1995) argued that while non-executive directors might be less effective in this regard than the expectations placed on them, they are not without effect although they may act more as a permanent constraint on management in limiting the scope of managerial opportunism (Hill, 1995; Huse, 2005). Given the recent strengthening of corporate governance codes and their emphasis on the importance of the board's control role, this constraint may be to some extent at the expense of their external service role and their relationships with stakeholders (Bezemer, Maasen, Van den Bosch & Volberda, 2007: Hill, 1995).

3.0 Stakeholder Activists and Engagement

While the past two decades have seen a rise in demands for better corporate governance and improved performance by boards, they have also seen a surge in social regulation as various "stakeholder" groups have organised themselves into powerful pressure groups. A number of forces have contributed to the rise of the activist shareholder. Some experts point to changing corporate governance rules, which give investors more power in the election of directors. Others highlight the increasing role of pension plans and hedge fund investment groups which have produced investors who keep a close eye on company performance and value. An under-performing or turbulent stock market is a factor that gains investor attention – as with the present Wall Street and global financial market crisis

– and prompts activists into action. The rise of shareholder activism, the large growth in employee pension fund schemes and wider public concerns about environmental issues and corporate practices has played a key role in bringing CSR and related concepts such as stakeholder engagement into the limelight. Precedents are being set that recognise the legitimacy of shareholder input (e.g. via shareholder proposals[14]) into board decisions.

According to the Economist Intelligence Unit (EIU) (02/05/01) while the European region experienced around the beginning of the present decade a period of profound restructuring with a growing emphasis on shareholder value, the owners of Europe's corporate sector traditionally have had surprisingly little power. This has been due to restrictive voting rules on ownership and control which have concentrated corporate control in small groups of formally or informally preferred shareholders and have supported a status quo of change-averse traditional owners or groups of allies. Many European companies have multiple classes of shares, some with voting rights and others without. This means that key decisions in leading companies such as Swedish Ericsson and Anglo/Dutch Royal Shell can be determined by priority shareholders who represent very small amounts of the companies' capital. Even where shares with special voting rights are not issued, cross-holdings by friendly banks and corporations (which in 2001 accounted for 10 percent of total European stock market capitalisation but were declining) can ensure that the real owners of the business play little part in strategic direction (EIU, 02/05/01). However, indications are that shareholders at all levels, from institutional investors to individual minority shareholders, are developing activist strategies to take more control of corporate strategy.

Such changes are occurring for a variety of reasons including institutional investors who have grown more active and some large non-institutional investment funds which now specifically target under-performing companies. Small shareholder coalitions have also grown in importance. Drivers of these changes also include reform of capital gains tax, shareholder impatience and a high level of merger and acquisition (M&A) activity. Other trends include greater transparency requirements, with many European companies listing in the US and moving to US accounting standards (which in turn has generated shareholder activism as more has become known about hidden value); the internet, with online collaboration among minority shareholder groups that increasingly include well-informed individuals such as former senior executives from target companies; the euro which has expanded institutional horizons with the elimination of intra-European currency risk (but has increased other risks such as bad asset exposure) together with increasing cross-border equity holdings with a focus on portfolio-building; and the fall in industrial equity prices from the technology sector to the broad industrial economy with the accompanying financial downturn (EIU, 02/05/01).

3.1 Accountability and Control

Both the concept of CSR and the notion of corporate citizenship (CC) propose that firms should be accountable to, and therefore controlled by, society and not only by shareholders. Both views counter the neoclassical (agency) view that companies should be accountable

[14] Recent examples include Fortis shareholder action over the BNP Paribus merger, *Financial Times*, 11/02/09 Fortis shareholders reject BNP deal http://www.ft.com/cms/s/0/68065628-f84f-11dd-aae8-000077b07658.html and Elan over top management capability, *Financial Times*, 09/02/09 Investors urge shake-up of Elan's "arrogant" management http://www.ft.com/cms/s/67cedd18-f649-11dd-a9ed-0000779fd2ac,Authorised=false.html

only to shareholders who, as the ownership, are considered the *only* legitimate agent to sanction corporate results. The CSR and CC concepts instead contend that a company is accountable for the creation of organisational wealth for its multiple constituents and, therefore, accountability can be understood as social corporate control. However, within the neoclassical paradigm, where corporate control by society occurs through the market, neither the concept of CSR nor that of CC helps improve corporate accountability unless the concepts are accompanied by real direct pressure on companies. According to Valor (2005), it is the stakeholders themselves (for example, shareholder or investor activists) that bring about changes in corporate practices by incorporating their ethical values into their economic decisions, strategically giving or withholding their economic support on the basis of their moral values (for instance, through ethical or socially responsible investing (SRI)).

Valor (2005) argued that under these circumstances the operation of market forces will automatically lead businesses to reflect those values (as in "green" investments within SRI, for example) through a collective process termed "social competition" which is analogous to market competition. Social competition is considered necessary because any powerful organisation needs a form of real countervailing power to keep it performing effectively for both its own benefit and that of wider society (Frank, 2001; Valor, 2005). The incorporation of social values in the capital market, through SRI, is particularly significant because under the neoclassical paradigm it is precisely the shareholders who are the most legitimate actor to sanction failure and demand transparency. The impact of SRI on financial markets, combined with shareholder activism, has led to changes in business practices and to the creation of ethical indices (such as the Global Reporting Intiative's (GRI) index) (Valor, 2005).

According to Valor (2005) this set of behaviours involving changes within the system constitutes one of two conditions for corporate accountability. The concepts of CSR, CC and SRI have brought changes in the system by raising awareness among consumers, investors and employees. As a consequence the associated body of literature has helped to bring understanding and to reinforce the "market forces" that have been considered essential for the development of a corporate social conscience (Andriof & Marsden, 2000). However, under this paradigm, Valor (2005) contended that CSR/CC has only limited ability to improve corporate accountability. This is because of selective and only partial incorporation of ethical values by consumers in their market decisions on one hand and as a result of managerial capture on the other hand – that is, the potential for management to hijack the entire process, including the extent to which stakeholders are included or excluded – by strategically presenting in public relations exercises only the information management considers will promote the corporate image. In their reluctance to make the trade-off between profits and the common good, management capture may also be reflected in such actions as resisting stakeholder pressure by denying, ignoring, or minimising stakeholders' claims, with little impact on improving corporate accountability (Valor, 2005).

The second condition for accountability and social control of companies, according to Valor, requires a system or paradigm change where companies must be convinced that profits are not an end *per se* but must be compatible with other social needs. However, the systemic change cannot take place unless the first condition is met where changes are made within the system, because companies reflect the values of the societies in which they operate (Angell, 2000; Valor, 2005).

Arguments such as those put forward by Valor emphasise the self-regulatory, political "right" perspective in improving corporate accountability, with a preference for less regulation and where corporate behavioural change is brought about ultimately through market-related pressures. In such instances as the current financial crisis, however, the question arises as to whether changes in corporate behaviour are brought about on a sufficiently wide and meaningful scale when left solely to market forces.

Other ways of addressing the wider implications of corporate governance and accountability include CSR reporting (for example, rating and benchmarking to assess companies' triple bottom line (TBL) performance, including extensive sustainability reporting intended to provide greater transparency and disclosure to investors and other stakeholders on a range of financial and non-financial indicators) and the introduction of various stakeholder representatives on boards (Aguilera, 2005; Huse, 2005; Pfeffer, 1972). In CSR reporting, however, issues arise over what to disclose, when, and to whom – and for what purpose.

3.2 Corporate Social Responsibility Reporting

Social, environmental and sustainability reports, sometimes referred to as "the 10-K of the corporate conscience" (Cheney, 2004, p 12), are methods that companies may use to formalise their position on CSR, and assess their corporate responsibility performance. This reporting can reveal much about the way organisations prioritise their stakeholders. Different kinds of non-financial reporting systems intended to provide all stakeholders and not just investors with accurate information and prevent fraud have become an integral part of the business operations of many large international corporations. Non-financial information, such as the quality of risk management, strategic direction, and social and environmental performance can help stakeholders to understand a company's performance and strategy (Perrini, 2006).

Government agencies and non-governmental organisations (NGOs) have published their recommendations for benchmarking against standards such as those developed by the GRI (2000, 2002) to assist CSR reporting. Nevertheless, the more traditional topics on the environment, corporate philanthropy and employees receive much greater attention than broader issues relating to the external society (Kolk, 2003). Before social and environmental bottom lines attain the external significance of the financial bottom line, they need to be measurable and standardised. While the GRI guidelines lack the meticulousness and sophistication of the standards established for financial reporting, they nevertheless serve companies wanting to provide comprehensive narratives on relevant non-financial issues (Cheney, 2004).

While for corporations the prospect of meeting the demands for benchmarking put forward by organisations such as the GRI Index is challenging, indications are that their social and environmental responsibilities are being taken seriously and that these issues are gaining greater prominence in the business agenda (Clarke 2007). As cited by Clarke (EIU, 2005 p. 3, in Benn & Dunphy 2007 p. 228), "Until recently, board members often regarded corporate responsibility as a piece of rhetoric intended to placate environmentalists and human rights campaigners. But now companies are beginning to regard corporate social responsibility as a normal facet of business and are thinking about ways to develop internal structures and processes that will emphasise [CSR] more heavily. In the not too distant future, companies that are not focusing on corporate responsibility may come to be seen as outliers." These developments are substantial improvements on the earlier findings at the beginning of the decade by Owen, Swift and Hunt (2001).

Drawing on interviews with corporate managers, representatives of the (then) five major accounting firms, consultants and NGOs active in the field, Owen et al observed that despite seemingly endorsing active stakeholder engagement, current social, ethical accounting, auditing and reporting (SEAAR) practice amounted to little more than spin and empty rhetoric. Pessimistically, they concluded that in developing SEAAR an overwhelming emphasis on the part of corporations on promoting the business case (i.e. considering only the obvious commercial benefits as the rationale for or against adopting the practice) together with a profound reluctance to address the issue of corporate governance largely removes any potential for enhancing the accountability and transparency of powerful economic organisations. Most fundamentally, according to these researchers, failure to address the crucial dimension of corporate power (management capture) robs initiatives such as SEAAR of a much needed edge in transforming attitudes toward real engagement with stakeholders (Owen, et al, 2001).

Developments toward standardisation of SEAAR and other reporting mechanisms suggest that stakeholder engagement is rapidly and perhaps inevitably becoming an essential pre-requisite for successful pursuit of the reporting process.

3.3 Participation, Power and Corporate Democracy

The apparent commitment to stakeholder engagement seems to be limited to a desire to manage stakeholder expectations and balance competing interests whilst leaving much scope for the exercise of managerial discretion (Owen et al, 2001). As Korten (2001, p.236) wryly noted, "What is the point of having power if you cannot use it to externalise your costs – to make them fall on someone else?" Others sceptical of the value of stakeholder engagement through SEAAR and similar forms of reporting might concur with Groucho Marx (cited in Angell, 2000, p.5) who suggested that "The key to success in business is honesty and fair dealing. If you can fake that, you've got it made". Nowadays, however, under the microscope of information technology these qualities are more difficult to feign. Even so, Owen et al concluded that the activist edge of the early social audit movement with its emphasis on holding to account powerful economic organisations has been effectively subjugated by business imperatives and thus, such a process of stakeholder management has effectively displaced any meaningful moves towards expanding corporate accountability towards stakeholders (Owen, et al, 2001).

In support of this claim, Owen et al were critical of the business case oriented approach underpinning SEAAR which they believed leads to at best a soft form of accountability where organisations engage in stakeholder dialogue for the purpose of voluntary self-reporting on their trustworthiness as part of a reputation-building process. Such a process, which lacks inbuilt institutional rights to information, does little to advance notions of participative democracy because current power differentials between organisations and their non-financial stakeholders remain unaltered and hence 'mutual vulnerability' fails to be established (Owen et al, 2001).

Critics view the normative idea of firms acting in ethical and socially responsible ways as appealing but unsatisfying (e.g. Ray, 2005). The contention is that corporations might articulate a devotion to ethics and corporate responsibility so long as these values do not conflict with other interests, such as maximising sales revenue, cost reductions, profits, perceived competitive advantage over competitors, or managerial autonomy. When ethics and corporate responsibility come into conflict with one or more of these goals, it is likely that intention will succumb to reality and the former will suffer relative to narrower and purely commercial interests. Every firm has an implicit hierarchy of interests and in the best of all possible worlds they might respond appropriately to all of these interests while in reality corporations will select which interests to pursue and which to ignore.

These conflicts of interest lead to the question of power and who holds it in the modern corporation. Which group of actors has the power to define the hierarchy of interests that any firm will pursue at those critical junctures when one set of interests takes precedent over another is a question of corporate governance. Current corporate governance excludes from the decision process those who are often most affected by corporate decisions (Bebchuk, 2007; Krohe, 2004, Ray, 2005). The reforms following the spectacular failures of Enron, etc. at the start of the millennium failed to address the basic issue of corporate power. According to Ray, the changes enacted in 2002 including the Sarbanes-Oxley Act and rules changes by the SEC and the New York Stock Exchange (NYSE) reflect a minimalist approach to corporate governance and its regulation. The intent is to provide the minimal amount of regulation to governance in order to keep investors committed to stock markets. Effective reform in corporate governance, Ray contended, means making corporate boards more representative and democratic (Ray, 2005).

4.0 Stakeholder Representation

The notion of interdependent relationships between companies and their stakeholders accords with a view of the modern corporation as a democratic social system[15], where the role of the board is to mediate and balance competing stakeholder interests in the corporate decision making process (Ingley & van der Walt 2004a). To align wider interests, calls are thus emerging for a new participatory system of "political" or democratic corporate governance where stakeholders could voice their competing "claims" and "prospects" to the directors acting as mediators (e.g Kostant, 1999). Kostant acknowledged that although it may be difficult for directors to deal with the subtle problems of balancing the rights and needs of stakeholders, the moderation of relationships is the essence of substantive law. Thus, moves toward such a model for corporate governance might require the support of regulation in addition to social and market forces.

Such a participatory system to uphold stakeholder interests within corporations might be through stakeholder representation on boards of directors to ensure a formal role in corporate decision making and promote CSR (Selznick, 1992). For example, voting rights on corporate boards have been suggested for employees and local communities, to help provide greater checks and balances (Child & Rodriguez, 2003). Boards might also appoint stakeholder directors to monitoring or supervisory committees such as audit committees. Indeed, board accountability and responsiveness to public concerns are reinforced in corporations that operate in highly regulated industries. Because of their size, large corporations are more visible, and thus attract greater attention from stakeholders such as government departments and the general public. Accordingly, researchers have

[15] By contrast the shareholder perspective is consistent with a view of the corporation as an oligarchy.

found a positive relationship between organisational size and level of CSR engagement (Luoma & Goodstein, 1999).

In practice, however, Hill's (1995) study of boards of directors of major British companies showed that "sectional" interests are often abhorred, because they threaten teamwork "and prevent boards pursuing the general good of the company, [uninfluenced] by other considerations" (p.257). Such sectional interests might include employees, parts of the business, or banks. Among directors in Hill's (1995) study all schemes for employee representation at board level were treated with hostility and outside interests, such as banks, were firmly excluded from representation on unitary boards.

By contrast, chemical, oil, and pulp and paper manufacturers, being industries under close public scrutiny because of their threats to the environment, are examples of US companies that have appointed prominent environmentalists to their corporate boards. This strategy has allowed them access to sophisticated expertise on environmental issues, contradicting the conventional theoretical view of directors acting solely as watchdogs for the company's shareholders, rather than for its broad community of stakeholders (Huse & Rindova, 2001).

4.1 Investor Representation and Influence

As highlighted by Sullivan & Kelly (2008), shareholders are seeking access to the boardroom as never before and are increasingly demanding attention. For example, as part of the movement for participative corporate democracy, cumulative voting (a proportional voting method) has been mooted by minority shareholders for electing directors to board positions (FairVote Program www.fairvote.org). Activists expect to communicate with boards today on issues ranging from strategy to results, mergers and acquisitions, to company leadership – and sometimes they want a seat on the board itself.

According to Ray (2005) homogenous and self-perpetuating boards do not guarantee the development and implementation of a sustainable corporate strategy. He argued that whether or not such boards are independent does not appear to be decisive and in their homogeneity they are more likely to be associated with the worst consequences of 'group-think' and the limitations of corporate 'dominant logic'. Self-regulation, he suggests, will only represent the interests of society if the diverse interests of society are represented on a firm's board of directors (Ray, 2005).

Ray (2005) argued that external regulation, the next line of defence against abuses of corporate power, is a two-edged sword. Regulation, he contended, may be heavy-handed, inefficient and counter-productive in finding a proper balance between the interests of society and the interests of corporations. Ray posited further that authentic corporate democracy in the election of boards fundamentally challenges the myth that corporate management left to its own devices will produce the most good for the most people while being efficient, competitive and strategically astute (Ray, 2005).

The primary vehicle of reform is seen to be the board (Aguilera, 2005; Ray, 2005; Roberts, McNulty & Stiles, 2005). Ray (2005) identified some basic structural and process changes that can drive the corporation towards becoming a more representative and democratic institution. He argued that democratic reform can and should be compatible with strategic clarity, competitiveness and operational efficiency. On the premise that "good corporate governance" is grounded in more democratic corporate governance, Ray contended that this does not mean that firm performance becomes irrelevant, because good performance is instrumental to social responsibility. If the board of directors is a bridge between a corporation and its environment then the composition, selection, qualifications and duties of the board is a critical issue. Representation is thus about an institutional process by which the voice of the governed is heard and taken into account by those doing the governing (Bebchuk, 2007, Krohe, 2004, 200Ray 2005). Ray favoured a more diverse and representative board, which, he claimed, is likely to have more legitimacy among shareholders and among the larger community of stakeholders (Ray, 2005).

This position draws on the work of scholars arguing for more diversity on boards and builds on the presumed advantages of diversity for better decision-making and strategy formulation. Ray stated that some of the most compelling arguments for a more democratic corporate process have come from those seeking more representation for minorities and women in corporate governance as a means of creating more opportunities for minorities and women in senior management. Ethnic and gender diversity is presumed to be associated with better managerial decisions and the advantages to heterogeneous boards (Ray, 2005).

However Ray (2005) believed that change won't come easily, contending that it most clearly won't come from minimalist reforms in response to periodic dysfunctions in corporate governance that remain embedded in the status quo. Change is more likely to come, he suggested, from pension funds, labour unions and organisations taking on the cause of small individual investors (e.g. by groups such as American Association of Retired Persons (AARP)). Since diversity is a likely result of a more representative and democratic process, groups committed to diversity are also natural allies of a democratic movement (Ray, 2005).

The key question arising from this idea is how a board can engage meaningfully with these investors to benefit the company overall. Sullivan and Kelly (2008) recommended several ways board members can ensure a positive result from investors' or an activist (stakeholder representative) board member's efforts to exert influence. These essentially involve a pro-active relationship management strategy by the board, while keeping a focus on the long-term objectives of the company. According to Sullivan and Kelly and growing numbers of commentators (e.g. Watkin, 2008*)*, the active involvement of shareholders can be on balance a good thing for both companies and shareholders.

Best practice in corporate governance implies that competent and effective boards of directors will provide the necessary leadership to their organisations for ethical and responsible conduct in pursuing high levels of corporate performance. As noted by Herman and Renz (2004), criteria for judging effectiveness are evolving and boards that understand their key stakeholders through effective communication and keep abreast of these performance requirements are likely to be regarded as effective. In the face of growing public attention to social and environmental issues, boards are finding that these concerns do have a material impact on performance. They affect reputation and other intangible assets and have direct bearing on financial performance.

From this reasoning it follows that companies that understand environmental, social and governance issues as being central to their success and manage them effectively, create value. Rather than seeing CSR as yet another demand for compliance, such companies have begun to recognise the concept as presenting a new business model and an opportunity for building innovative forms of competitive advantage, as demonstrated in rising returns to SRI stocks or the development of alternative fuels and fuel systems for automobiles (Grayson & Hodges 2004; *The Wall Street Journal*, 06/10/08, p.30). Boards are instrumental in shaping and overseeing such strategies and active engagement around what it means to be a responsible and responsive enterprise can strengthen the board's potential as a strategic influence on long-term value creation (Cramer & Hirschland 2006, Davies 1999, Healy 2003, Kiel & Nicholson 2003, Schacter 2005).

4.2 Leadership Role of Boards

The ideological distance between the shareholder orientation and the stakeholder perspective is reflected in a report by Tyson (2003), one of many official reactions to the Higgs review, which suggested that greater boardroom diversity (e.g. in knowledge, skills) could improve relationships with corporate stakeholders, such as customers, employees and shareholders. However, competence as a director is not simply a function of professional and industry-based managerial (namely CEO) expertise, which are the skill-sets most emphasized among shareholders and traditional selection criteria for board appointments. To be effective boards require directors with additional skills specific to the director role, including strategic thinking capabilities, team and leadership abilities, and especially, a good understanding of the difference between managing and governing an organisation, which cumulatively delivers value to the organization in the form of board capital. While CEO experience brings many of the required commercial skills to a board position, the role of governing is distinct from managing in crucially important ways. While executives are required to implement decisions agreed in conjunction with the board, the strategic role of directors, as promoted by the resource dependency perspective, is essentially to provide leadership for the organisation. Leadership from the board is a key factor for success in championing a corporate strategy for managing external relationships and stakeholder engagement.

Board capital is formed from the strategic resources contributed by directors to their organisations and is a key element of the leadership provided by the board that adds value to the organisation. Hillman and Dalziel (2003) identified board capital as combining both the human capital and the relational capital of the board members. Relational capital, sometimes called social capital, is the sum of the resources derived from the network of relationships possessed by an individual or social unit (Hillman and Dalziel, 2003). Both kinds of capital can contribute to the general resources provided by executive and non-executive directors to their organisation, which in turn strengthens firm performance. These resources include timely information, advice and counsel, building external relations, providing firm legitimacy and reputation, maintaining channels of communication between the firm and external organisations, and helping to acquire resources from important outside parties (such as financial capital) (Hillman and Dalziel, 2003).

Carpenter and Westphal (2001) highlighted the kind of advice and counsel provided by directors who had ties to strategically related organisations (relational capital). Certo, Daily and Dalton (2001) posited that the prestige of directors (board capital) could enhance the credibility and performance of the organisation. The contemporary view is that the quality of the board and its relationship with the top management team, as well as with key external stakeholders, is a key element of winning organisations. Recent research by Hubbard et al., (2007) into long term high performing organisations in Australia identified a consistent set of leadership characteristics at the most senior levels including the board.

The leadership style at the executive and top team level is dependent on the particular organisational needs and stakeholder expectations at a specific time and the position of the organisation in its strategic cycle – an ability to adjust rapidly to changing needs is a key characteristic of success.

However, there is no magic leadership formula. Board capital enables the exchange of valuable information by providing channels of communication between the firm and external organisations, thereby reducing some sources of uncertainty (Hillman and Dalziel, 2003). In this way board capital can aid in acquiring resources or secure legitimacy from important elements outside the firm (Zald, 1969) and provides the rationale behind the idea of stakeholder engagement by corporations (especially with investors) through leadership from their boards.

Hillman et al. (2002) extended the concept of board capital, proposing specific categories of director as contributors to board capital. These categories include business experts, support specialists such as lawyers, and those influential in the community such as politicians or university representatives. This view suggests that in the selection of board members, a conscious choice from a wide variety of different types of director experience is necessary to maximise board capital and the board's portfolio of skills. This notion also provides a rationale for stakeholder representation on boards and is associated with the idea of corporate democracy.

A board is a group of people selected for their expertise, who work together to add value to the organisation they lead. Although diversity in boards of directors is far from being a requirement *per se*, it is crucial in the service role, but the benefits are less documented in the strategic role. Board composition that achieves diversity involves alternative director selection processes. To assemble balanced boards, that is, a mix of executive and non-executive directors as advocated by the agency perspective on the role of boards, behavioural traits of directors and other interpersonal and political dynamics play a key role. Boards thus need to be aware of the potential to add value through the pool of board capital contributed collectively by their directors as a strategic resource for their organisation. This board capital is a measure of the value added by the board in its governance role. Consistent with resource dependence theory, researchers have linked board capital directly to the provision of resources and firm performance.

5.0 New Zealand Boards

Detailed codes of best practice derived from extensive official United Kingdom (UK) reviews and related regulation that have resulted in a sharp increase in board and director responsibilities and liabilities in other developed countries since the mid-1980s. Similar requirements for New Zealand boards are found in such legislation as the New Zealand Companies Act 1993, the State Owned Enterprises Act 1986, and numerous other regulatory enactments. Most New Zealand boards of directors serve small and mid-size firms, usually with up to five or six directors. The largest source of new directors is from the traditional pool of management and the existing boards (Directions, 2007).

With regard to how New Zealand boards view their socially-related obligations and external relations with their stakeholders, Ingley (2008) reported that the majority of directors in a (2004) survey believed that the internal tasks of the board such as involvement in strategy, evaluating CEO performance, determining risk exposure and responsibility for ethical conduct were very important. However, the importance assigned to the task of reviewing social responsibilities was rated significantly lower in importance by these respondents and was ranked low overall amongst other board tasks. When questioned further on board capabilities, most respondents perceived their fellow non-executive board members' competence as of a relatively high standard with regard to the various strategically related skills, with the exception of contribution to the CEO's and management's performance. Consistent with the relatively lower importance assigned to reviewing their social responsibilities, their understanding of stakeholders' issues was likewise rated relatively low.

A further question in the same survey rated board skill requirements on strategically related criteria in terms of their level of influence in director selection. The most influential criterion in director selection decisions regarding building and maintaining strategic capability on the board was that of possessing industry-specific expertise. Understanding the risks facing the organisation, and ability to represent shareholders' interests recorded scores indicating only average influence in the selection process, yet these are key areas of governance responsibility for directors. The ability of a director to assist with networking and to provide introductions to key contacts also had relatively low influence as selection criteria, the latter result being consistent with respondents' rating of their board's competence in this regard, yet according to resource dependency theory, this ability represents potentially a key resource for the organisation and an important contribution by the board in its external service role (Ingley, 2008).

When asked about the influence they believed their boards had on key corporate activities, close to 40 percent of the respondents reported a strong influence in their company's relationship with shareholders, yet only 20 percent rated their board's influence as strong when it came to relationships with key stakeholder groups. Considerably less than 20 percent (16.6%) of respondents believed their board was strongly able to influence the company's risk exposure and less than 6 percent felt they could strongly influence media perceptions of the organisation. The result regarding influence on risk exposure was especially notable when compared with the higher levels of importance attached by respondents to determining exposure to risk (Ingley, 2008). Furthermore, what is understood by "risk" and whether or not all potential risk factors are included in the company's risk profile is an interesting question. In the context of this discussion, it could be debated as to whether potential risk factors associated with stakeholder management, such as reputation risk and its downside impact on the firm's survival, are fully understood by these firms (Ingley & van der Walt, 2008). Such risks are less obvious, not traditionally included in risk management policies, and potentially lethal in a toxic market environment such as prevails in the current financial crisis.

The overall results of the study indicated companies whose boards had neither fully acknowledged the importance of, nor cultivated the competences required to, engage with their external stakeholders. Together these findings underscored an insularity among New Zealand boards which was especially evident in the relatively low emphasis placed by respondents on external linkages as potential contributors to the board's value in providing social capital for the organisation. Comparing the results with an earlier survey by Ingley and van der Walt (2001), the level of influence for these items was similar in both studies, suggesting little progression in terms of developing an outward orientation and external responsiveness over the five-year interval. The survey result also highlights a closer alignment by corporate boards in New Zealand with the narrower shareholder capitalism perspective than the stakeholder model of corporate governance. Insofar as these boards are indicative of the current level of commitment to CSR as part of their governance role, New Zealand companies (with some exceptions) are not aligned with leading thought and best practice as demonstrated by those such as are rated in the GRI and other sustainability indices (Ingley, 2008).

The present survey revisited these issues with the addition of an investor perspective regarding their relationship with and expectations of boards of New Zealand companies.

6.0 Research Method

The 2006 mailed-out survey in New Zealand was repeated with a 2007 edition of an on-line survey, distributed to shareholders, corporate executives and current directors. Distribution of the survey was facilitated with support from several large organizations in New Zealand through their databases (PricewaterhouseCoopers, ANZ Bank, Business New Zealand, Crown Company Monitoring Advisory Unit, Ministry of Women Affairs, NZ Shareholder Association, NZ Venture Capital Association, several universities, etc.). With a good regional distribution throughout New Zealand and representation of all industry groups, these organizations distributed invitations to members of their networks and databases to complete the on-line survey. Depending on whether the respondents were owners, or shareholders, or directors, they were directed to different segments of the survey instrument, thus allowing for data capture specific to the expertise and role of the respondent.

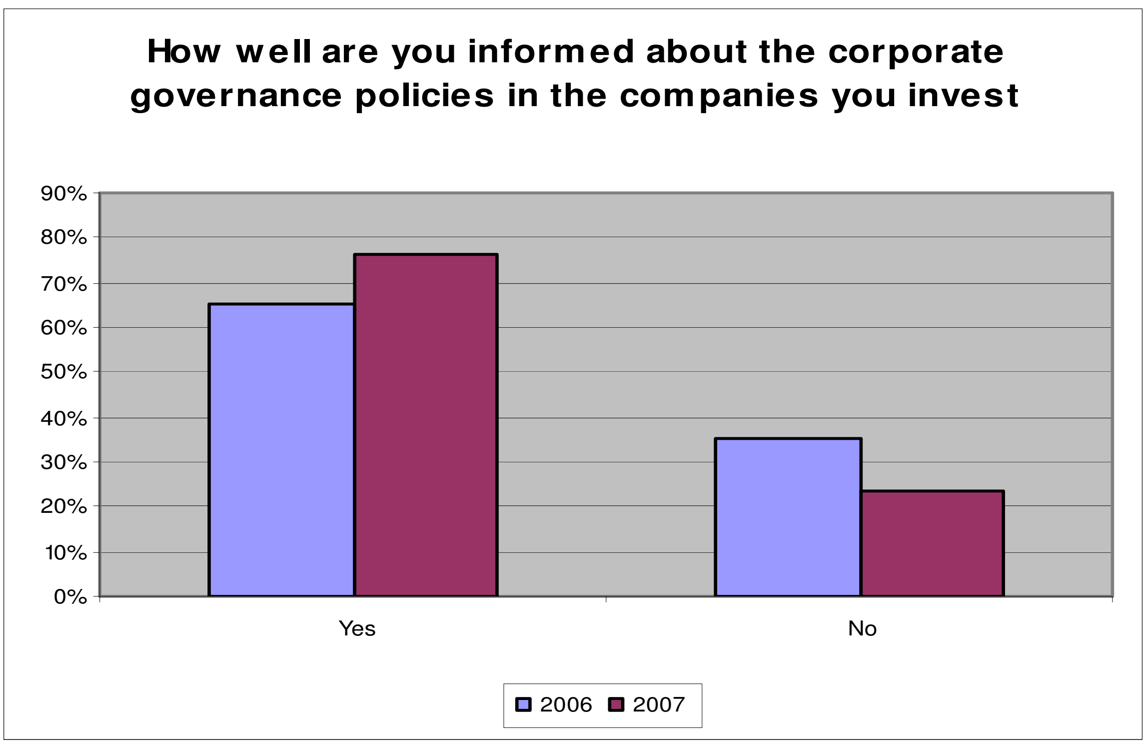
With 1,800 responses received in 2007, comparable to the 2,100 responses from the previous year (2006), this is one of the largest non-government surveys on corporate governance in New Zealand. The results from both surveys are cumulative, being derived from consistency in the survey instrument, questionnaire design, distribution, respondent characteristics and industry representativeness, as well as in responses. This means that the results from both surveys can be combined for discussion, with the 2007 results confirming those of 2006 and thus providing a comprehensive picture of corporate governance in New Zealand.

Respondents were filtered in the questionnaire so that some completed only one section of the survey, many completed two sections and few completed all three sections. More than 63 percent of all respondents requested a copy of the results report, indicating more than a passing interest in this topic. On that basis we conclude that corporate governance is an engaging topic among SME leaders as well as those of large businesses and investors in New Zealand, since many of the respondents' companies can be defined in this way. With public battles over whose director candidates should sit on the Telecom board or where to seek accountability for failed finance firms, the topic of good corporate governance is high in media interest in New Zealand.

7.0 Results and Discussion

In the context of transparent governance policies we presumed that an effective element of that transparency is the communication to stakeholders. We asked shareholders of New Zealand registered limited liability corporations how well they believe they are informed about the corporate governance policies of the companies in which they invest. Our assumption was that firms that are satisfied with their governance processes and policies and attribute value in sharing this information with existing and prospective shareholders will communicate those processes and policies to establish strong stakeholder relationships based on trust and confidence in the leadership principles of the firm. This would indicate a stronger emphasis on governance than the minimum periodic reporting that is required by regulators or through the annual general meetings, even if most shareholders were attending those meetings.

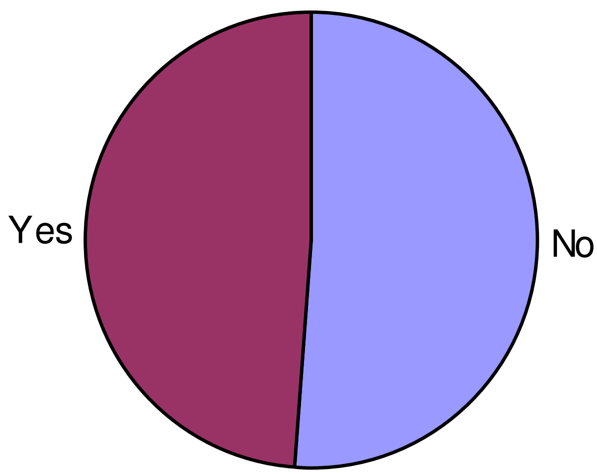
Our survey results indicate that the percentage of shareholders that are "not well informed" about governance policies is declining from 2006 to 2007 (and early indications for the 2008 results show a further slight decline), hovering around 20 percent. Given the large number of very small, family-owned and agricultural (farm) businesses in New Zealand[16] where shareholders, who by virtue of being sole owner-operators, should be very familiar with governance policies of their (own) firms, we suggest that a 20 percent or greater share of shareholders without such transparency is high as a national average. We note, however, the encouraging trend in this figure which has declined over a 3-year monitoring period. We postulate that a positive change in this percentage is likely to be an indication of different and improving governance behaviour of firms and thus, is meaningful (Graph 1). On the other hand it could be surmised that the relatively high level of knowledge of governance policies claimed by shareholders indicates some complacency on the part of firms that might argue that an 80 percent rate of shareholder satisfaction with the firm's governance transparency is "as good as it gets". It may also indicate passivity among some shareholders who are not more demanding for better information about the governance processes and policies of the firms in which they invest.



[16] Of approximately 470,000 firms in New Zealand, in excess of 90 percent are classified as small and/or sole proprietorships http://www.stats.govt.nz/products-and-services/media-releases/nz-business-demographic-statistics/nz-business-demography-statistics-feb08-mr.htm

Graph 1: Are you well informed about the corporate governance policies in the companies in which you invest (Yes/No)?

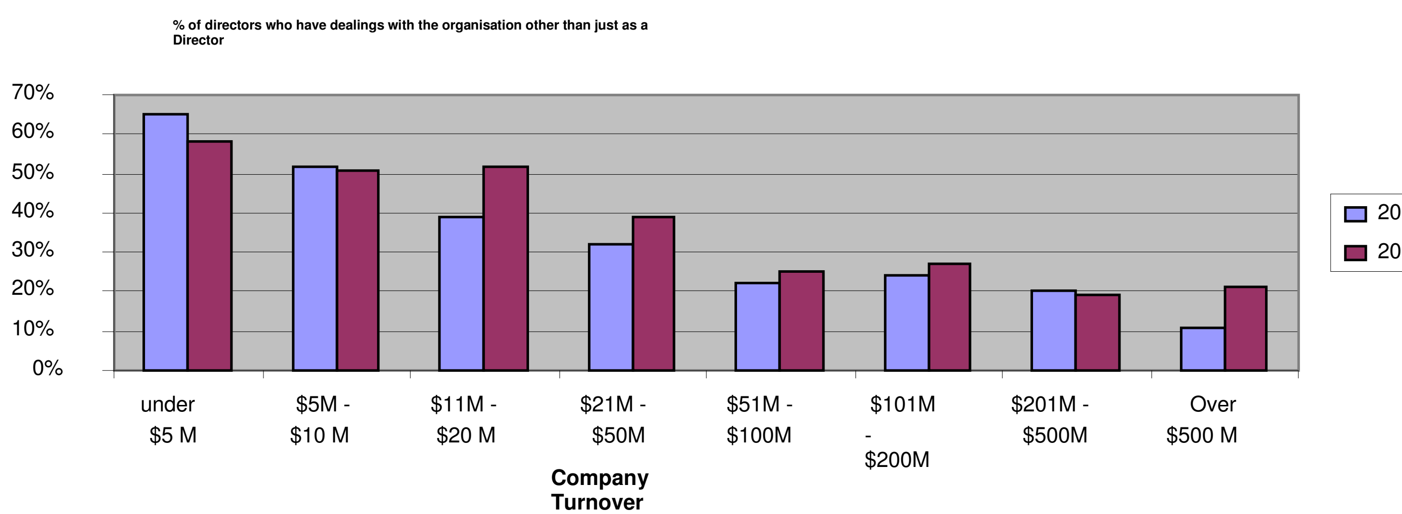
To further understand whether corporate entities in New Zealand take active measures to manage and balance conflicting interests at board level, we asked whether firms have a formal process to identify and manage this issue. More than 53 percent of firms did NOT have such a process, and we speculate that unless such a process is installed and made part of the regular framework of board operations, the opportunity is high for conflicts of interest to taint the boards' decisions. Recent high-profile cases of board conflicts, such as a board member of a large health board also being the major owner in a private firm bidding for a NZ$1/2 billion laboratory contract with a health board, highlight the likelihood that conflicts of interest exist in many boards where directorships are recruited from local executive talent and that a management process for those conflicts would be helpful to avoid uncertainty and legal action (Graph 2).



Graph 2: Does your firm have a formal process to identify and resolve conflicts of interest for Directors?

A significant body of literature, including our own published papers, indicates the important contribution external non-executive directors make to the transparency and independence of board decisions. Given New Zealand's relative geographic isolation where company directors are sourced from a small pool of senior executives and often through referrals from other insiders (Mueller et al, 2006), the appointment of independent directors on boards seems to indicate how corporate social responsibility can be discharged through the board that has a reduced potential for executive self-interest to dominate decision making. In this context we surveyed New Zealand firms as to the percentage of truly independent directors, i.e. those who have no dealings with the firms on whose boards they sit, other than being a director. This filtered out directors who are also the firms' accountants, solicitors, suppliers, etc. and thus provides a clearer picture of the potential conflict of interest level of board members. Given the large amount of publicity about independent directors, we note that for mid-sized firms with more than NZ$10 million in sales our data does not show an overall increase in the proportion of independent directors on New Zealand boards from 2006 to 2007.

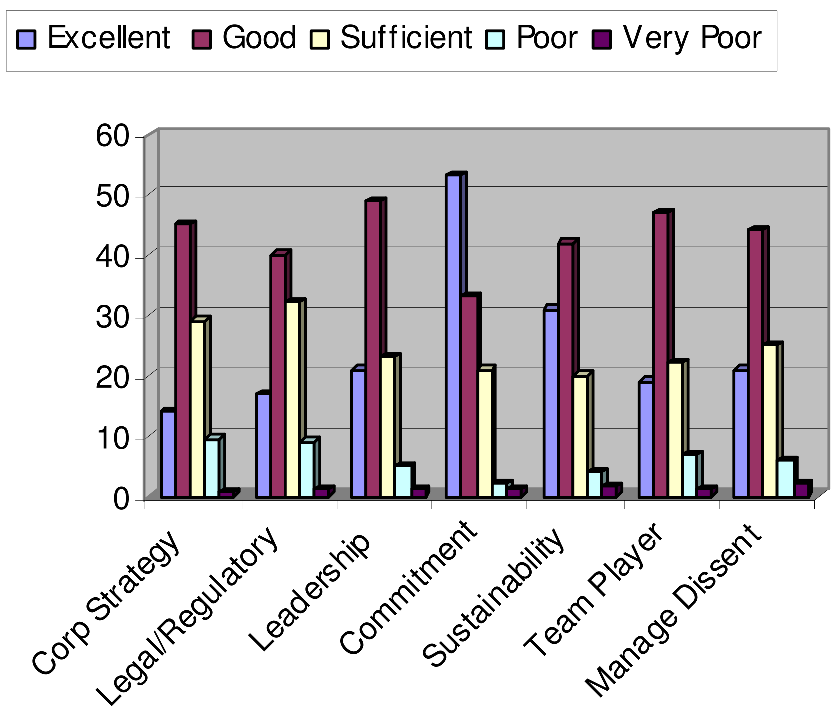
By contrast, however, for larger firms with annual sales of more than NZ$500 million, the number of non-independent directors actually increased over the period covered by the two surveys. Only the SME category of firms with annual revenues below NZ$10 million showed a decrease in the number of insider or executive directors in 2007, this being most marked within the category of the smallest firms with revenues below NZ$5 million. These results suggest that the majority of New Zealand's corporate boards do not provide truly independent oversight and may help to explain the low levels of shareholder and key stakeholder engagement and low priority of corporate social responsibility evident from Ingley and van der Walt's (2001) and Ingley's (2008) research. With a greater concentration of insiders on these boards it is unlikely that wider, socially-related concerns will have any real influence on strategic deliberations. This apparent trend toward insider entrenchment is inconsistent with the general drive towards a greater number of independent directors on boards and requires further monitoring to establish whether this two-year data set marks the beginning of a negative trend away from corporate governance best practice guidelines (see Graph 3).



Graph 3: Percentage of directors who have dealings with the organisation other than just as a director (first column: 2006; second column: 2007).

As part of our conviction that good governance is an essential ingredient in the sustainable growth of responsible entities worldwide, we examined New Zealand firms' standard of corporate governance. We speculated that good governance could be exhibited by those directors who have skill sets at an acceptable level in the key areas where boards become active in the decision-making process. To mitigate the self-aggrandisement effect we asked respondents for an assessment of the competence level across the board. We were surprised by the outcome showing that only in one category, "Commitment", did the directors rate their board's competence as "excellent", and by evidence of a marked decrease in ratings of board competence in all other categories, especially in that of "Legal/Regulatory/Audit".

This result runs counter to the development of good governance in that the majority of company directors are highly committed to holding their seat on the board but otherwise lack specific skill sets, especially in compliance-related areas where they are expected to provide effective oversight on behalf of the shareholders. We cannot determine from our data whether this result is a function of a number of factors, individually or in combination, that include a lack of training available to directors, a lack of awareness of the need for and commitment to develop the appropriate skills, or deficiency in the search and selection process that appoints new directors. Nevertheless, this is a cause for concern, especially in conjunction with findings from other research suggesting that, besides being inwardly focused, New Zealand boards fall short on key areas of competence and best practice relative to their counterparts in other developed countries (see Graph 4).



Graph 4: Rate to which extent you and your fellow directors are competent in these areas (first column = Excellent Competence, second column = Very Good Competence, third column = Good Competence, fourth column = Satisfactory Competence, fifth column = Poor Competence)

8.0 Concluding Comments

Since the 1990s, the study of corporate governance has been dominated by a focus on protecting the stake of investors in corporations, and thus on agency conceptions of the tasks and roles of non-executive directors, in particular. However, boards also serve their companies by performing important service roles such as providing advice to management and legitimising the corporation in relation to other important stakeholders. Non-executives play a crucial role in linking boards with the outside world and in this way can influence powerful external interests (Bezemer, Maasen, Van den Bosch & Volberda, 2007; Hill, 1995).

The neoclassical paradigm which espouses the discipline of market forces and the agency view has emphasised the board's control role and the importance of independent, non-executive directors. As previously stated in this paper, independent directors are thought to provide more effective oversight of the state of the company and a system of checks and balances to constrain managerial opportunism. Corporate governance structures based on the agency model comprise a corporate security system that has not always been effective in preventing corporate and governance failure, as evidenced by waves of corporate collapses throughout the last two decades, especially those associated with the current global financial crisis. As posed by Hill (1995), the question arises as to how well non-executive directors can perform the monitoring and control roles that the institutions demand in protecting the interests of shareholders, as embodied in ever-tighter corporate governance regulations and codes of practice, when managers prefer to pursue other goals.

CSR implies that corporations must address the social, environmental and economic concerns of stakeholders as well as the financial demands of shareholders. However, as the recent monumental events of the financial market meltdown have shown, the neoclassical view that societal control of corporations occurs through market competition alone has proven inadequate. While corporate social accountability and control derive from pressure from stakeholders who incorporate their moral values into their individual economic decisions and thereby influence corporate behaviour collectively through social competition, boards in their duty to the entire enterprise are required to serve not only as monitors of management in the interest of shareholders but also as mediators among all corporate stakeholders and to balance their competing claims and expectations. In their social role as buffers between the affairs of the corporation and its constituents, boards of directors set the tone of sincerity and ethical behaviour in decision-making and accountability within the organisation.

Although as elsewhere New Zealand directors have been faced with extended responsibilities and liabilities, CSR and the interests of stakeholders are not yet an important focus of their attention and activities. Indeed many SMEs have only begun to acknowledge the importance of appointing independent non-executive directors to their boards and in only beginning to formalise their internal governance structures and practices, are not yet ready to address the complexities of wider external social obligations. However New Zealand directors are not unusual among their international counterparts in seeking to maximise shareholder wealth as the object of governance, and in trying to ensure that corporate actions and assets are directed to achieving this aim. Neither are they alone in lagging behind international best practice regarding their responsibility to stakeholders, as indicated by studies in the UK and elsewhere (e.g. Dulewicz & Herbert, 2003; Elkington, 2007, Stiles & Taylor, 2001).

Given the wider demands that not only institutions but also wider society now places on companies as corporate citizens, boards of directors might need new, more inclusive and participative structures for governance with mechanisms that allow better processes for stakeholder engagement and relationship management. Such mechanisms might also need to allow a greater stakeholder voice in corporate decisions, or they may include stakeholder representation on boards, and regulation for social accountability.

The present global market crisis is widely thought to represent systemic failure in the capital market system. Reforms based on a new relational paradigm of corporate democracy rather than on simply continuing to shore up an outmoded and dysfunctional system must also cast the spotlight not only on oligarchic power dimensions but also the governance capabilities in the boardroom itself. If boards are to function as mediators among corporate constituents, they will require new competencies and leadership skills to facilitate collaboration, cooperation and effective communication in their interactions with their external environment (Ingley & van der Walt, 2004). Business schools and universities can make a major contribution toward developing the corporate social conscience and providing these new competencies required of executives and boards of directors.

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