Corporate Governance & Social Responsibility: Challenges Regarding Accountability

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Ewoud Jansen
Fontys University of Applied Sciences
International Business & Management Studies
Eindhoven, the Netherlands

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Author
Ewoud Jansen
Senior Lecturer Finance & Accounting, Fontys University of Applied Sciences
E mail: Je.jansen@fontys.nl

Biography
Ewoud Jansen received his education at Tilburg University, the Netherlands. He majored in Corporate Finance with a special interest in Mergers & Acquisitions and is the author of various Accounting & Finance textbooks. He also publishes on Corporate Governance & Corporate Social Responsibility issues and writes articles for several leading Dutch newspapers. Today he is a senior member of the academic staff of the International Business and Management Studies program at Fontys University in Eindhoven. In this capacity he also gives guest lectures at partner universities in various countries. In addition he acts as a trainer and consultant in international programs sponsored by the European Union, Worldbank and similar institutes.

Structured Abstract
Purpose
The emphasis on Corporate Social Responsibility affects Corporate Governance as it stretches the accountability of companies beyond its traditional boundaries. This however may conflict with the corporate objective of maximizing stockholder wealth. The paper provides an overview of various academic theories and corporate attitudes on this issue and discusses the merits and disadvantages of the two main governance modes: the stockholder mode and the stakeholder mode.

Design
The paper presents a literature review and an analysis of corporate statements, summarizing and connecting various academic – and corporate viewpoints on the matter of Corporate Social Responsibility and accountability.

Findings
The findings from the literature review and the analysis of corporate statements are used to formulate the conditions on how to integrate and balance the various stakeholders' interests with the objective of maximizing stockholder wealth.

Originality
Corporate Social Responsibility is widely embraced, both in academia and business. The concept however fails to provide clear decision criteria for prioritizing the often conflicting interests of various stakeholders. The paper addresses this issue and comes up with suggestions to bridge the gap between idealism and the need for making non-arbitrary choices.

Keywords: Corporate Social Responsibility, Corporate Governance, Accountability, Agency Issues, Corporate Objectives

Paper Classification: Viewpoint

Introduction

Few people will deny the sole proprietor running his corner store, the right to try to maximize his income. Of course he should conduct his activities within the limits of the law and with common decency but other than that, the goal of maximizing income hardly raises any objections. But should he incorporate his business and delegate the daily operations to a manager, at some point a feeling the business now has responsibilities towards a much wider range of stakeholders emerges. Consequently, management should pursue other goals besides the maximization of owners' income. Income gets a different emotional connotation when it is the income of a non-managing owner, rather than the income of an owner who manages his own business.

It is this shift in perception of owner's income that is at the heart of the ongoing corporate governance debate. Corporate governance can be defined as *'the set of principles and policies that determine the way in which a company is managed and accounts for its actions'.* Briefly summarized, the debate has two groups of contenders. There are those who state that companies primarily exist to serve the interests of their owners while others hold that companies should serve the interests of a wider group of constituents.

This controversy has kept politicians, social activists and academics from various disciplines busy for many decades and it has been spurred onwards by the accounting scandals of the early 2000's and the financial crisis of more recent years. The rise of Corporate Social Responsibility (CSR) can be seen as proof that both in theory and practice, it is widely believed that managers should not merely look after the interests of the owner(s) but should serve the interests of an unspecified range of other stakeholders too. If management should serve the interests of more groups, it can also be held accountable for its actions by these groups. This effectively means that CSR extends the boundaries of governance and finds its way in codes of conduct and legislation.

This paper argues that the academic and public policy debate is blurred by misunderstandings and misperceptions on both sides of the arena. It sets out to clarify the background of the misperceptions and to align the different viewpoints.

Roles and Goals of the Corporation

Organizations should serve a purpose in society otherwise they can not exist. Informal organizations, say a group of art enthusiasts, can simply exist for the joy and shared interest of its members. But other, more formal organizations that depend on outside funding, can only survive if they can legitimize their existence to the outside world. This is where governance enters the equation.

Publicly funded organizations like public schools exist for the people and by the people. They can exist as long as they can provide the education that the people as tax payers are prepared to pay for and as parents want for their children.

Privately funded organizations may exist for any number of reasons. A particular kind of organization is the business enterprise. It exists to provide goods and services to paying customers with the intention of generating an income for its participants.

The key characteristic of a market transaction is reciprocity. In a free market economy, transactions occur when they are mutually beneficial to the parties involved. A business enterprise can only exist if it has a product or service to sell to somebody else who is voluntarily willing to pay for that offer. Such a person will pay a price below the value the product has for him. And the business enterprise in turn will sell it for a price that exceeds the value of the inputs that were used to create the product or service. Thus business transactions create value for all parties involved and do they benefit society at large. The difference of the price for which the goods are sold and the value of the inputs needed to create these goods, is the income or profit that accrues to the owners of the business.

A business can only increase its profits when it uses fewer – or pays less for – scarce inputs to generate a given output or generate more or better quality output given a quantity of inputs. In both cases society would benefit too. If the business uses fewer inputs, these may be allocated to other beneficial activities. If output can be increased, it means more value for paying customers. Ever since Adam Smith (1776), economic theory has embraced this mechanism as the reason why the quest for profit is a positive driving force for human advancement. The dynamics how reallocated inputs create new activities and businesses have been elaborately discussed by Schumpeter (1942). Workers losing their job in obsolete industries while new employment opportunities arise elsewhere is an example of the mechanism that Schumpeter called 'creative destruction'. Without a quest for profit, this mechanism will not function, causing the economy to be stagnant.

As stated in the introduction, few would contest the right of the owners to maximize their income if the business is a sole proprietorship. This is no longer the case when the business is incorporated and characterized by a division between owners and executive managers.

Stockholders vs. Stakeholders

The quest for profit being the overriding goal of a corporation, was introduced in American corporate law following the 1919 Dodge vs. Ford Motor Company decision of the Michigan Supreme Court. It stated that "A business corporation is organized and carried on primarily for the benefit of the stockholders."

This ruling was followed by heated debate among academics. The most influential publication in the inter-bellum years came from Berle & Means (1932). They analyzed the operations of businesses owned by absentee stockholders and warned for 'corporate plundering' by non owning managers, essentially taking a stockholder primacy position. Contracts between management and stockholders should be formulated in such a manner as to minimize the agency costs that result from separating ownership from management and allowing for stockholder value maximization. Berle & Means' views provided the cornerstone of what became known as the 'contractarian' view of the corporation. Meanwhile Coase (1937) reasoned corporations are essentially tools for coordinating activities that can exist when they reduce transactions costs.

Berle (1931) also locked horns over this issue with Dodd (1932), who explicitly argued for serving wider, non stockholder interests since according to him the corporation was

an economic institution which had a social service as well as a profit making function. In the following decades, legislation shifted towards viewing the corporation as an 'entity' of its own and with its own obligations, rather than as just a tool for stockholder wealth creation.
The ideas of Berle & Means were, however, not forgotten. Jensen & Meckling (1976) built upon their work and modeled the agency relations in a rigorous and mathematical manner. Their approach advocated the neoclassical style cost benefit analysis with the maximization of the market value of the firm as main goal.
Both in the academic and public arena, the contractarian approach to corporate law dominated the corporate governance debate and policies in the 1980's and 1990's.
Scholars from the management & organization departments of business schools felt ill at ease with the stockholder primacy mode that resulted from the contractarian view. They advocated that management should pursue a wider range of objectives than merely looking after the interests of stockholders and developed the so-called 'stakeholder theory of the firm'. Freeman (1984), the theory's leading proponent, states that stakeholder theory "identifies the relevant set of actors in the environment of the business." He defined a stakeholder as "any group or individual who can affect or is affected by a business."
The most important point of stakeholder theory is that stockholders are just a particular group of stakeholders, just like employees, suppliers and customers and that the interests of no single one group can be more important than those of others. Also they say that the contributions of all of those stakeholders are vitally important for the survival of the company. Of course this is undeniably true.
Pursuing a single objective (market-value maximization) then, does not do justice to the complex human interactions that are innate to doing business. Stakeholder theory does take these interactions into account. This makes the theory "managerial" as Donaldson & Preston (1995) put it. Stakeholder theory "does not simply describe existing situations or predict cause-effect relationships; it also recommends attitudes, structures, and practices that, taken together, constitute stakeholder management."
Freeman *et al.* (2004) also raise moral objections against the stockholder primacy model when they state that "maximizing shareholder value is not a value-neutral theory and contains vast ideological content. At its worst, it involves using the prima facie rights claims of one group – shareholders – to excuse violating the rights of others." They also argue that "the rights of shareholders are prima facie at best, and cannot be used to justify limiting the freedom of others without their consent."
All of this implies that management should look after the interests of all stakeholders, not only those of the stockholders.
Stakeholder theory rightly emphasizes the importance of human relations in business.
It is a point of view that seems to have no place in classical economic theory and its models with maximizing economic actors. Stakeholder theory does have a major flaw however. It does not provide a criterion as to *how* the interests of the various stakeholders should be prioritized in case of conflict.
Employees want higher salaries and job security. Customers want low prices and high quality and suppliers want the best possible deal for their contribution. In the end it's management's job to make trade offs between these often conflicting interests. A theory that claims to be more managerial than the stockholder primacy model should provide

managers with the tools to make such tradeoffs. Jensen (2001) says that “it is the failure to provide a criterion for making such tradeoffs (among stakeholders), or even to acknowledge the need for them, that makes stakeholder theory a prescription for destroying firm value and reducing social welfare.”
Blair (2005) states that “stakeholder theory has, so far, failed the rigorous model test and continues to be rather ad hoc.”
Tirole (2001) finally, notes that “management can almost always rationalize any action by invoking its impact on the welfare of some stakeholder.”
In other words, stakeholder theory does not provide adequate decision making criteria.
The stockholder primacy model, however, does have an unbiased and clear criterion for making decisions. This criterion says that the company should only devote resources (to certain stakeholders or anything else) if it increases the market value of the firm. This criterion forces companies to use their resources efficiently. This is something that certainly benefits many more than just the stockholders. Organizations that use their resources efficiently and effectively contribute to a more prosperous society.
While the stockholder approach trumps the stakeholder theory in terms of analytical rigor, the stakeholder view has won the battle for the hearts and minds of the general public and the business community alike. Nowadays’ omnipresence of CSR in corporate strategy is clear testimony to that fact.

Doing Good by Doing Well

CSR has arrived. Once mainly advocated by activists and special interest groups, it now is a mainstream business philosophy. The European Union has formulated a code of conduct that businesses should adopt. Other governing entities follow suit. Myriad rankings exist that judge and compare companies on the social – and environmental sustainability of their operations. Large, stock exchange listed companies especially, can’t afford not to have a CSR policy. All twenty-five companies comprising the Dutch AEX stock-market index report on their social responsibility over the year 2011. Twenty of them published a separate sustainability or CSR report while five have integrated their social reporting in the regular annual report (see Table 1 below for details). All of them refer to their responsibility towards the communities in which they operate, the environment and their stakeholders.
CSR and the stakeholder theory are closely related as they both emphasize a wide range of constituents and interests to be taken into account. As a result, many CSR different definitions exist. But they do point in the same direction. Following an extensive study, Dahlsrud (2008) identified five key elements frequently included in CSR definitions:

-Economic value creation
-Environmental value creation
-Social value creation
-Stakeholder relations
-Voluntariness

With countless potential financial, societal and environmental goals and objectives to strive for, difficulties arise when making choices and prioritizing objectives. And if stakeholders exists both within and outside the firm as Hopkins (1998) suggests, the accountability of companies is stretched far beyond the traditional boundaries of agency relations.

So CSR suffers from the same flaws as the stakeholder theory. They are both opaque concepts lacking in operational clarity. This is actually not denied by their proponents. Stakeholder theorist Freeman (1994) says "stakeholder theory is thus a genre of stories about how we could live." Freeman et al. stated that "stakeholder theory can be many things to many people."

Besides being ill defined, both stakeholder theory and CSR have their roots in feelings of distributive injustice of the economic and other benefits that result from corporate activities. This explains the popularity of both CSR and the stakeholder theory. It touches on basic human emotions and feelings of 'community', 'belonging' and 'fairness'. Agle & Mitchell (2008) acknowledge both this and the fact that the theory still suffers from operational vagueness when they say "While stakeholder theory is instinctively pleasing to many (which may account for its growing popularity), its ease of use in concrete, deep-conviction stakeholder-based management, the explanatory efficiency and power of its theoretical underpinnings, and its simplicity in implementation, continue to be works in progress."

The stockholder approach does not have the innate appeal of the stakeholder approach. It arouses emotions that are quite different. Using Agle & Mitchell's words, this may account for its unpopularity.

Aversion & Animosity

Religious beliefs are among the oldest emotions of mankind. Through religion, views of the universe and man's place in it and standards as to how he should act were shaped. These standards also related to business and trade which are unalienable facets of human behavior. Both Jewish, Christian and Muslim doctrines teach how to use money ethically. In the Torah, landowners are urged not to reap the entire yield of their harvests but to leave the proceeds from the edges of the fields to travelers and the poor. The present day word in Arabic for profit is 'Rib', derived from the term 'Ribah' which in the Holy Quran means usury.

In medieval Christian times, restrictions based on the Old Testament existed regarding loans and investments. The Catholic Church declared a ban on usury in 1139 that was only lifted in the 19th century. The Quakers who settled in North America in the 17th century did not want to benefit from the trade in slaves and weapons. The founder of the Methodist Church John Wesley (1703 – 1791), preached that people should not engage in sinful trade and should not enrich themselves by oppressing and exploiting others. The Old Testament phrase 'by the sweat of thy brow thou shalt earn thy bread' is clear testimony to the fact that man should labor and toil to earn his keep. As a result, income earned from renting out assets (be it money or a tangible asset) to others is frowned upon. It is deemed unfair and a form of exploitation. Banks and moneylenders have never been the most popular members of society in the eye of the general public.

As stated in the introduction, there is no widespread animosity towards people earning an income – and profiting from their own labor, be it as an employee or an entrepreneur. For the entrepreneur, however, this income is not only compensation for his labor, but also for making choices and willingness to take risks.

Whereas in a sole proprietorship these three functions are united in one person, in a corporation they are necessarily separated. This separation is the main advantage of the corporation as it allows for the creation of businesses with economies of scale that can never be achieved by sole proprietorships or partnerships. These economies of scale became especially important when during the 18th and 19th centuries new technologies like the steam engine allowed for mass production and transportation of goods on an unprecedented scale. This fuelled economic growth and prosperity everywhere this mode of economic organization was adopted. But besides growth and prosperity, the corporation also fuelled something else, something deeply embedded in the human psyche: animosity towards investors that profit not from their own labor, but from that of others.

For many people, the notion of large corporations owned by absentee stockholders is simply too abstract. It clashes with deeply human emotions that include a sense of belonging and community. It leads to not seeing the stockholders as the rightful residual claimants of the business as these stockholders do not have a personal role in the business. This very estrangement and depersonalization makes many regard the corporation as some public entity, the proceeds of which can be freely and justifiably distributed among any constituent.

Dodd (1932) already noted that "public opinion, which ultimately makes law, has made and is today making substantial strides in the direction of a view of the business corporation as an economic institution which has a social service as well as a profit making function." His words were prescient and true and do predict the advent of CSR. The governance mode of stockholder primacy is increasingly and more successfully being criticized. But while developing a stakeholder based governance mode continues to be work in progress this is no reason to therefore discard the criticism as irrelevant.

Shortcomings of the Stockholder Model

The animosity mentioned above is strengthened by the claim that maximizing the returns to stockholders is the main goal of the corporation. This incorrectly suggests that stockholders are more important than anybody else. It may incline managers to violate the rights and interests of others. While in the long run this almost always will result in hurting profitability, and thus the interests of the stockholders, the short term bias is there.

According to traditional corporate finance theory this should actually not be possible since in efficient capital markets the value of a business does not depend on the next fiscal quarter's earnings but on all future profits. When maltreatment of a certain stakeholder does endanger long term profitability, this should be reflected by today's change in market price, thus giving managers a clear signal to refrain from their actions. Short term response of stock-markets is not always this efficient though. It is true that many managers focus on ratios like earnings per share (EPS) when making decisions.

Focusing on this ratio and setting higher targets for every coming fiscal quarter can indeed make management ignore the long term. It is the curse of EPS that makes managers not invest in positive net present value projects as a study conducted by Graham *et al.* (2005) has shown. In this study, 78% of the managers surveyed confess they will not undertake positive net present value investments if they feel the investment will hurt the short term EPS. Managers indicated they think stockholders will not react kindly to a (temporary) drop in EPS with a lower stock price as a result. However, if the investment indeed does has a positive net present value, the stock price should react positively. Managers should be able to explain the consequences of proposed investments and be able to motivate their choices for investments that temporarily lower the EPS.

Both managers and stockholders need to understand the danger of focusing on a simple statistic like EPS to assess company performance and value. Enron's management proudly claimed to be *"laser focused on EPS"* in their 2000 annual report. We all know how that ended. Enron's management did not serve their stockholders nor any other stakeholder group.

The Nature of Accountability

Governance essentially is about having a set of checks and balances in place. It is about clearly defining who can be held accountable for what and by whom.

As a legal entity, a corporation can be fined for misconduct. But in the end the misconduct was the result of managerial decisions and the fine reduces available residual income and is thus paid by the stockholders. As a legal fiction, a corporation cannot truly be accountable to anyone. The contractarian approach of the corporation clearly acknowledges this fundamental truth. The so called realistic approach, advocated by stakeholder theorists, which portrays the corporation as a separate personality with its own rights and obligations does not. The contractarian view stipulates that ultimately it is people who have interests, rights and obligations. In that sense it is actually compatible with stakeholder theory with its focus on relations between participants in a business. In fact, stakeholder advocate Wood (2008) underlines this when stating that "institutions do not exist to serve their own purposes, but rather to serve the needs of societies and their peoples."

You are accountable to those on whose behalf or under whose authority you perform a task. So to whom is a corporation, or more correctly, management by which it is represented, accountable? Its merits for identifying the importance of various stakeholders in creating business value notwithstanding, stakeholder theory, even after decades of research and thought, provides no coherent answer to this question. Managers cannot at the same time be accountable to both suppliers and stockholders for instance since these two parties essentially have divergent interests in the negotiating process. Management does not act on behalf or under authority of the supplier but rather engages in a contract and contact with the supplier that can only endure if it is mutually beneficial. This is as stated above the essence of a free market transaction.

Management also does not act on behalf of the employees either. It does not represent them. Also here, management engages in closing contracts. Of course labor contracts

are typically more personal than those with the more distant suppliers and there certainly is a form of responsibility of employer towards employees. But governance wise, employees are accountable to employers rather than the other way around as stakeholder theory seems to suggest. In the end managers do represent the stockholders and are therefore first and foremost accountable to them.
What stakeholder theory implies, is that where – and whenever there is a relationship, there is or should be a form of formal accountability. This is and cannot be true in all of those cases. Accountability to stockholders may be dubbed as ‘old school governance’ by Gill (2008), but there is no ‘new school governance’ that provides a consistent, coherent and workable framework that can replace it.

Conclusion

The main achievement of stakeholder theory is to put the human element back into the discussion about business and theories of the firm. The human element that traditional economic theories indeed tend to ignore. Business relations are indeed not entered by one dimensional value maximizing economic actors driven only by monetary gain. Traditional economic theory and the governance mode built upon it, lack the heart and soul that business practitioners and the general public crave for. Now, with corporate – and financial scandals fresh in mind, public trust in business and capitalism is at historically low levels. While the outrage is justified there is a great risk that this “leads political leaders to set policies that undermine competitiveness and sap economic growth” as Porter and Kramer (2011) put it.
One such undermining policy would be to enforce multi accountability on business. Scholars like Gill (2008) are captivated by the opportunity of “turning companies into semi-public entities.” This is a dangerous road to travel. It opens up all kinds of opportunities to disperse corporate resources to any constituent that happens to be in the center of the public’s attention. This is not necessarily the most productive one. Turning private investments into public property makes investing less attractive. Ultimately it will increase the cost of capital and rob society of the benefit of countless new innovations that history proves are much more likely to be fostered in a private sector economy than in a public one. Moreover, it is governments that are responsible for the ‘common good’. Putting corporations in their position gives governments an incentive to shy away from their responsibilities and reduces their accountability to the general public.
Stakeholder theory may be more appealing to the general public, it does not overcome the shortcomings of the stockholder accountability mode. Also when other stakeholders enter the governance model, the danger of a short term horizon is still there. The accusation of being driven by blind greed usually solely falls on investors or stockholders but other stakeholders are by no means free from trying to serve their own interests either. Implementing governance modes that address other stakeholders than stockholders therefore is no guarantee that business will be run in a more ‘fair’ or more ‘democratic’ way. The ‘greed’ of the stockholder is restricted by way of the stock-market that factors in the contributions and value of other stakeholders. While these

markets are not fully efficient as theory suggests, similar liquid markets regarding other stakeholder's interests are absent.

Unlike other stakeholders, most stockholders today are actually not in a position to actively influence or negotiate their share of the corporate pie. They invest their resources and as residual claimholders can only hope for the best. Stockholders are not in any special position of privilege. The only real privilege they have is that of limited liability. Brammer *et al.* (2012) argue that society must place responsibilities on corporations in exchange for this legal privilege, apparently assuming limited liability is basically a cost to society.

It is true that in the case of corporate bankruptcy, the limited liability of the stockholder becomes the collective liability of society. But equally true is that under the protective shield of limited liability businesses and products can be created at a cost far below than would otherwise be possible. Limited liability is thus an asset to society. Of course society does place responsibilities on corporations and often rightly so, especially in the case of so-called externalities. Imposing costs like pollution of the environment on society, without paying for them may result in unfair gains for stockholders. It is equally true though that in otherwise competitive markets this gain may fall in the laps of the customers who pay a price for the goods that is too low.

Where negative externalities are concerned efforts must be taken to internalize such costs so that they become part of the sales price. In the end all production occurs for the sake of consumption. If consumers are not prepared to pay a price that includes the cost of these externalities, investments will naturally move elsewhere. Market mechanism type ways of internalizing externalities such as companies paying for CO_2 emission rights are to be preferred. When this cannot be done in a market mechanism fashion, ultimately government should intervene. It is all good and well to expect companies to do the right thing voluntarily as CSR advocates like to see but this does not mean we can do without legislation to create a level playing field.

In developed countries the rights of stakeholders such as employees are already well protected. So much so that in fact in certain countries their position has become so entrenched it hampers economic vitality.

In countries with weaker legal systems rights of stakeholders are less well protected. It is still possible for companies or their subcontractors to make use of weak or absent labor rights regulations or environmental protection in many parts of the world. But the world is now a very transparent place and such behavior is more rapidly exposed than ever before, forcing managers to respond. Many would like to see the response is rooted in changing moral convictions. Others may say it's just adapting to market forces. The latter it most certainly is. Today, moral convictions of the public are a market force. In many cases this is a positive force but it can also result in unjust pressure of specific special interest groups.

All of this does not alter one basic fact however. In the end, management does represent one group of stakeholders in particular: the non-managing stockholder. Ultimately that is the group to whom managers are accountable. Focusing on narrow statistics such as EPS can be destructive as Enron's fall has shown. Rather accountability should involve explaining how well the corporation manages the contributions of all other stakeholders to ensure long term value creation. The latter can only be assured when businesses really have something worthwhile to offer to customers and treat all their stakeholders fairly. The corporation does not exist solely to benefit the stockholders. That is not its 'raison d'être'. That is simply impossible.

Stakeholder theory has taught us an important lesson. One that many managers, stockholders and economists had forgotten. But while the creation of stockholder value is not the reason why companies exist, it is an important decision criterion for managers to judge and be judged by. Let's not forget another lesson. When society puts the cost of increased societal awareness solely on the shoulders of stockholders it means it's all of us that will pay the price by way of less prosperity.

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Table 1. CSR reporting by AEX listed companies

Company	**Separate CSR Report**	**Integrated CSR Report**
Aegon	√	
Ahold	√	
Air France KLM	√	
Akzo Nobel	√	
Aperam	√	
ArcelorMittal	√	
ASML	√	
Boskalis	√	
Corio	√	
DSM		√
Fugro		√
Heineken	√	
ING	√	
KPN	√	
Philips	√	
PostNL		√
Randstad	√	
Reed Elsevier	√	
Royal Dutch Shell	√	
SBM Offshore	√	
TNT Express		√
TomTom		√
Unibail Rodamco	√	
Unilever	√	
Wolters Kluwer	√	