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Does governance system prevent unethical practices in sustainable citizens firms?

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Abstract

The objective of this research is to check if sustainable social status is an explanatory framework or a constraint for the development of opportunistic strategies. Based on a specific sample, which is sustainable citizen companies along the period 2002-2007, we examine - in panel and comparative studies - financial, governance and social characteristic of these firms. Our findings identify several important facts. First, our results show inefficient governance to curb managerial discretionary. Second the earning management can be a strategic tool to get a sustainable ranking on the list of the "100 best citizens corporate ". Finally we discover a new type of entrenchment which is social entrenchment on social top lists. These findings highlight the opportunistic practices even in ideal companies.

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INTRODUCTION

Introduction and hypothesis development

Sustainable citizens firms are supposed to be leaders not only in promoting social responsibility but also with durable compliance in practices.

Therefore, all else things are equal, these companies are able to preserve their places on social list along considerable time, means they have typical control structure that allow them to be selected as citizens firms for more than one year.

Hence, This suppose that these firms have efficient mechanisms of governance able to reduce the tendency towards opportunistic strategies (Brickley and al, 1988; Baysinger and al, 1991; Baysinger and Hoskisson , 1990; Baysinger and Butler, 1985; Arlow and Gannon, 1982).

Research objectives

Under this direction, we are interested in this paper to examine four points:

- The first is to determine if sustainable citizens companies can be more disciplined than not sustainable citizens companies.
- The second is to investigate the efficiency of their governance mechanisms.
- The third is to determine whether these mechanisms can be able to curb earnings management practices.
- The fourth is to test whether the addition of social status to governance mechanisms can reduce discretionary decisions.

Therefore, the hypothesis of this research is:

H: sustainable social firms may have non efficient governance mechanisms

The remainder of the paper is organized as follows. Section 2 provides the sample and data collection. Section 3 describes the econometrics approach. Section 4 reports and analyzes the empirical results. Finally, Section 5 concludes.

2 Sample and data collection

To validate our hypothesis, we rely on a sample composed of eleven firms which have remained classified during six years from 2002 till 2007 on the social list of top citizens firms.

The data are taken from different documents: proxies statement and financial reports published on Fortune500, sec.gov, Edgarscan, YahooFinance, firms websites

3. Econometric Approach

We present the definition and the descriptive statistics of governance variables of sustainable citizens firms as well of non sustainable citizens firms. Notably, we emphasize on discerning a difference between their characteristics through a comparative analysis.

In this comparative study, we intend to determine whether there are significant differences between governance mechanisms in sustainable corporate citizens and in others non sustainable companies which were not been able to preserve their ranking on six social lists. The sample of companies witness is selected from the list of "Fortune 500" so that it is made up of companies with characteristics similar to sustainable corporate citizens (in terms of size , degree of debts ...) .

Then, through some regressions representing the relationship between social performance and governance mechanisms, we want to identify which mechanism may be significant to assure a social commitment.

As we examine the effectiveness of these mechanisms on earning management. Finally, we look also at the combined effect of these mechanisms and of the degree of citizenship on earning management.

4. Empirical results

4.1 Mechanisms of governance and descriptive statistics

In tables below we define the variable of our study, we give the summary of statistics results and we present the result of comparative test successively.

Table 2 : List of variables

ROA	Return on assets
ROE	Return on equity
Discretionnal Accrual (AD)	Level of earning management ¹
Size (SIZE)	Log of total employees
R&D (RD)	Research and developement expenditures
Debtes (D)	Debt Ratio
FCF	free cash flow
Sales	Sales level
Board size (BS)	Measured by the number of directors on the Board.
Board activity (NMB)	Frequency of annual meetings.
Corporate social responsibility committee (SC)	Dummy variable takes the value 1 of there is a commitee in the company and 0 otherwise .
CSR committee activity NMSC	Frequency of annual meetings.
Outsiders (OUT)	Number of external directors presented in the Board of Directors
Managerial ownership (MO)	The percentage of shares held by the team managers
Manager duality (DUAL)	It takes the value 1 if the manager (CEO) is at the same time , the chairman of the board and 0 otherwise .

¹This variable was calculated basing on estimation of Dechow and al 1995 model.

Blockholders (OINST)	The percentage of shares held by institutional investors.
Tenure of the CEO(TENU)	assessed by the number of years at the company's head.
Compensation of manager(COMP)	Salary+bonus+others annual compensation annuelle of the CEO
Sector reglementation(REG)	Dichotomous variable taking 1 if the firm belongs to the CIS (4000.6000 et2830) and 0 , otherwise . According to Scott (1987), the most highly regulated industries are controlled and in this case the managers will be less engaged in discretional decisions.
Social litigation (LITG)	Dummy variable taking 1 if it exists and 0 otherwise.
Code of conduct²(COD)	Dichotomous variable taking 1 if the company adopts this code and 0 otherwise .
Publication of social report(PUBSR)	Dichotomous variable taking 1 if the company publishes a social report and 0 otherwise .
Customers(CUST)	All these variables are determined scores according to criteria of 100 best companies as established by "Business Ethic Magazine "
Employees (EMP)	
Environment (ENV)	
Diversity(DIV)	
Community(COMMU)	
Social Score (S)	

In the table below we present means values of these variables and the result of comparative test

In fact, in order to determine whether the mechanisms of governance of sustainable corporate citizens are more effective than non- sustainable business, we used the comparative ANOVA test to detect significant differences.

² «This code is a statement of high standards for ethical behaviour and legal compliance, and it governs the manner in which firm conduct its business. Our Guideline for Business Conduct (our "Guideline") summarizes the compliance and ethical standards and expectations we have for all our employees, officers (including our principal executive officer, principal financial officer and principal accounting officer) and directors with respect to their conduct in furtherance of Company business. It contains procedures for reporting suspected violations of the Guideline, including procedures for the reporting of questionable accounting or auditing matters, or other concerns regarding accounting, internal accounting controls or auditing matters. The Company has established a Business Ethics Program through which employees and others may report, anonymously and in confidence, concerns regarding such matters». Annual report:www.sec.gov

Table 3: Result of comparative test and mean values

Governance Mechanismes	Sustainable citizens firms	Non sustainable citizens firms	Test (ANOVA)	
			Fisher	Sig
MO?	4.665000	4.163182	2.114529	0.002948***
INSTO?	15.75576	25.78576	1.252916	0.365745
COMP?	3394259.	2236437	4.175407	3.38E-08***
OUT?	8.787879	9.000000	1.850583	0.014182**
DUAL?	0.409091	0.469697	1.030389	0.904314
TENU?	5.833333	6.590909	1.156988	0.558343
BS?	10.78788	10.86364	1.011284	0.964060
NMB?	6.287879	7.924242	2.258095	0.001249***
LITG?	0.121212	0.045455	2.455026	0.000387***
SC?	0.333333	0.303030	1.052174	0.838182
NMSC?	1.303030	0.893939	1.799127	0.019189**
COD?	0.833333	0.924242	1.983607	0.006444***
AGE? ³	54.77273	56.89394	1.172404	0.523225
REG?	0.378788	0.181818	1.581790	0.066733*

*, **, *** : Thresholds risk level of 1% , 5% and 10% , respectively.

From the first glance we can notice that in sustainable corporate citizens, the size of the board, the number of meetings and the presence of external recommendations are very similar to values recommended by the codes of conduct.

Moreover, it appears that managers have more shares in sustainable firms than others non sustainable.

It seems also that compensation shows a strong significance. It appears that managers get higher salary in sustainable citizens firms than not sustainable.

However, the presence of the external is less significant in this type of business.

In addition, the boards of these "sustainable citizen" companies seem to be less active than those in other companies, although they are faced with a greater number of disputes.

In contrast, social committees seem to be more active in the sustainable corporate citizens. Still to know the nature of their decisions are taken for which partner? In other words, are their intense activities for social purposes? Or to revise financial reports ?

It seems that these sustainable social enterprises are less likely to adopt codes of conduct than other companies. However, they are subject to external regulations.

We present the average values of social scores of sustainable corporate citizens in the table below:

Table 4 : Descriptive statistics : mean values of social variables

PUBSR?	SCORE?	COMMU?	DIV?	EMP?	ENV?	CUST?
0.712121	0.872898	1.547424	1.175742	1.447424	1.099061	0.719636

PUBRS is the variable indicating that the company has published CSR reports.

Only 71.21 % of companies publish their reports on their websites. This publication may have several interpretations. It can be understood as a desire to show their transparency and integrity as it could be a means of seduction to influence visitors to these sites. In addition, these reports contain and provide for public filtered and selected information, which may make them less credible.

On average, these companies seem to be more likely to meet the community and other stakeholders. Customers remain the last stakeholder to be taken into account .

Together, these companies have , on average, higher scores in almost all services to various stakeholders.

We can discern more different social orientations for each sustainable corporate citizens in the following table :

³ The same for AGE : 3.934698 et 0.049407

Table 5 : Mean scores for each social sustainably Corporate Citizens

	SC	NM SC	COD	COMM U	DIV	EMP	ENV	CUST
AUTOD	0	0	0.83	1.38	1.90	0.691	0.15	0.41
NORTH	0.83	2.83	0.83	-0.15	0.10	2.68	1.13	0.48
ECOLAB	0.33	1.66	0.50	2.27	0.28	-0.22	1.65	1.75
PITNEY	1	3.83	1.00	1.14	2.27	0.22	1.50	0.19
CISCO	0.16	0.66	0.83	2.36	1.68	1.62	0.59	0.56
STARB	0	0	1.00	2.48	0.77	0.94	0.73	-0.02
SOUTHW	0.16	0	0.83	-0.07	0.95	3.15	0.15	1.53
TIMB	0.33	0.50	0.83	2.8	0.45	0.96	1.18	0.56
INTEL	0	0	1.0	1.23	1.63	3.32	2.47	0.46
HERMR	0	0	0.83	0.008	1.90	0.96	2.98	1.39
CUM	0.83	4.83	0.66	3.51	0.94	1.56	-0.45	0.56

It is interesting to notice that "Intel" - corporate social leader - seems to be reluctant to adopt a social committee. However, it is the most efficient and socially especially for its employees.

Though, the company " Pitney " seems to have the most active social committee over the six years. It has adopted the code of conduct during this period. However, it is not the most successful socially, being more prone to diverse business interests.

This suggests that having a social and adopt a code of conduct committee cannot be strong criteria to get a high score.

The company " Cummins " is more interested by the community.

The company " Herman Miller" pay more attention to environmental actions , given the nature of its industrial activity.

While customers seem to be the most interesting stakeholder for the company " Ecolab ".

4.2 Impact of governance structure on social score

To test this relationship, we propose to estimate the equations in the following table

Table 6 : Governance models

Model 1 : Average score =f (Governance mecanismes + control variables)

Model 2 : ROE =f (Governance mecanismes + control variables)

Model 3 : score customer=f (Governance mecanismes + control variables)

Model 4 : score employees=f (Governance mecanismes + control variables)

Model 5 : score environment =f (Governance mecanismes + control variables)

Model 6 : score community =f (Governance mecanismes + control variables)

Model 7 : score diversity =f (Governance mecanismes + control variables)

We present the results of these estimates in the table below:

Table 7: Estimation results of the regressions of governance mechanisms on social performance

	Average score	shareholders	Customers	EMPLOYEE	community	Diversity	Environment
MO?	-0.013835***	0.001882	0.027149*	-	-	0.002536	-0.008548
INSTO?	0.002835	0.001649**	0.004549	0.067911**	0.011769**	0.014515	0.005501
COMP?	8.07E-09	4.11E-09**	3.41E-08*	9.53E-08***	-7.87E-08**	3.98E-08	-7.59E-08**
OUT?	0.026753	0.007776*	-0.079389	0.224088**	0.126355	0.139160*	0.060376
DUA?	-0.008691	-0.034533*	0.102403	0.184148	-	-0.133842	-
					0.315997**		0.398702**

TENU?	-0.003897	0.003678	0.030782	-0.048125	0.035811	0.084825** *	0.047418
BS?	-0.016778	-0.000931	-0.027821	-0.069317	- 0.277050** *	-0.015885	-0.055253
NMB?	-0.009734	-0.003018	0.004089	-0.026737	0.182713** *	0.006816	0.033187
LITG?	-0.001753	0.008480	-0.060630	-0.233510	- 0.406474** *	0.271321*	-0.133131
SC?	-0.043309	-0.037070**	-0.144678	0.159891	-0.085101	- 0.715705** *	0.136008
NMSC ?	-0.000557	0.005730	-0.037123	0.056530	-0.038425	0.078848	0.170075**
COD?	0.058168	0.054767***	0.279860***	- 0.462902**	0.197227	0.403463*	0.000879
AGE?	0.000471	-0.001957	-0.003933	-0.007849	0.008469	-0.028667*	-0.006025
REG?	-0.379669	-0.003242	-0.094653	-0.903882*	-1.516040	0.565144	0.962379*
PUBSR ?	-0.393562	-0.034943	2.245436***	-0.421879	-2.191708	0.839163	-0.601657
D?	0.202139	0.188530***	0.351155	- 1.431646**	2.236165**	1.520658	-0.630247
SIZE?	0.009048	0.008663**	0.038423	0.002910	- 0.132672** *	-0.081183*	-0.057830
FCF?	-1.062126**	1.059836***	-1.245202*	-1.324807	1.355243	-0.243232	-0.809305
RD?	-0.410312	0.064235	0.000404	-2.039538	2.446489	1.415475	-0.626721
R- squared	0.907330	0.951383	0.950060	0.900517	0.890199	0.859030	0.860439
D-W	2.828054	1.497889	1.862559	2.250382	2.317788	2.168285	1.474605
F-Stat	19.58201	39.13775	46.85196	18.10399	16.21470	12.18740	12.33065
PF-Stat	0.000000	0.000000	0.000000	0.000000	0.000000	0.000000	0.000000

*, **, *** : Thresholds risk level of 1% , 5% and 10% , respectively.

We find that managerial ownership has a highly significant effect on the social performance with negative correlation. This can be explained by the existence of a negative entrenchment strategy.

However, other mechanisms seem ineffective to motivate a social commitment. This assumes that the maintenance of the social ranking due to other characteristics which are related to intrinsic characteristics of these companies : the nature of the business activity, size, efficiency, financial performance and most importantly, discretionary strategies of managers.

For the other estimations tell us about the impact of these mechanisms on social policy for the six stakeholders.

Shareholders relationship :

The governance model better supports a shareholder trend (high value of the adjustment coefficient in this estimation) . This suggests, perhaps, that good financial performance is the most criteria for sustainable ranking. Therefore, these mechanisms seem more likely to defend the interests of shareholders, notably .the recommendations of Code of conduct, showing a high significance(99%)

Institutional investment seems also significantly defend the interests of shareholders as well. While, the presence of the social committee seems oriented to satisfy others stakeholders.

Based on the coefficients of fixed effects of each of these companies, we were able to identify six of eleven companies that have had a positive relationship with the stakeholder.

Customers relationship

The ownership and managerial compensation are positively correlated to the customers ranking. The recommendations of the code of conduct seem to have a positive effect on customer orientation. In addition, the publication of reports is heavily involved in improving this relationship, given their advertising content.

Based on the coefficients of each of these companies fixed effects, we were able to identify four of eleven companies that have had a positive relationship with this stakeholder. These positive relationships imply that there are other factors intrinsic to the company, other than those of governance, which led them to satisfy this stakeholder

Employee Relationship :

Compensation and managerial ownership are highly significant and have negative effect on this trend. This can be explained by a negative effect of entrenchment and that this commitment is appreciated in terms of costs, thereby harming the interests of managers.

The code of conduct and external regulations seem to have a negative effect.

Thus, social ratings seem to be formulated according false signals that do not reflect objectively what is happening behind the social status.

Community relationship :

Seven governance mechanisms have a significant impact on this trend. Five of them have a negative correlation with this stakeholder.

Indeed, the number of disputes has a negative impact on this relationship. These disputes can cause significant degradation of the image and reputation.

A very large board could also be interpreted as a bad structure, because of conflicts of interests that it would generate.

Moreover, compensation, duality and managerial ownership appear to be constraints for a commitment to the community.

High institutional investment may direct the company to take social action for the community.

The fixed effects are higher especially in cases of ECOLAB and TIMBERLAND companies (accordance with the descriptive statistics).

Diversity relationship :

Diversity appears to be strongly defended by the recommendations of the Code of Conduct and the presence of external directors in the board.

The age, against the variable tenure, seems to have a negative effect on the relationship with diversity. Four of the eleven companies seem willing to meet the the interest of this stakeholder.

Environment relationship :

It's interesting to reveal that the environmental actions seem to be controlled by the Social Committee. This may indicate that these committees are only interested on the natural environment (symbolic) and not by other stakeholders that can actually be affected by the activity of the firm.

However, managerial characteristics are negatively correlated with this stakeholder, given the costs that it generates. Ten companies except CUMMIN have positive fixed effects.

4.3 Impact of governance structure on discretionary accruals

To empirically examine this relationship, we define the model to be estimated as follows:

$AD = f(\text{governance variables} + \text{control variables})$.

We present the results of this estimation in the following table :

Table 8: Estimation result

Explicatives Variables	Coefficients
MO?	0.003908*
INSTO?	0.001783
COMP?	-3.87E-10
OUT?	0.001081
DUA?	-0.006429

TENU?	-0.009069
BS?	0.003968
NMB?	0.025738*
LIT?	0.013906
SC?	0.011020
NMSC?	-0.009703
COD?	0.007914
AGE?	0.004721*
REG?	0.091979**
PUBSR?	-0.227531*
ROE?	0.052169
ROA?	0.489760*
D?	-0.040341
SIZE?	-0.001685
FCF?	-0.575944
RD?	0.237169
S?	0.000668
R-squared	0.587331
D-W	2.490653
F-Stat	5.423569
PF-Stat	0.000108

*, **, *** : Thresholds risk level of 1% , 5% and 10% , respectively.

Where S ? is the social score

It seems that the managerial ownership had a significant positive effect on the level of earnings management (Bédard and al 2001).

Excessive number of board meeting can push managers to manipulate the results to be presented in these meetings.

It seems also that more managers are older , more likely they are to manipulate results of their firms in order to confirm their expertise as competent managers , leading bargains.

Sector regulations pushes further managers to provide good results.

However, the publication of the social report seems to be a way to curb accounting manipulation.

Overall, these mechanisms are unable to counteract the earnings management and limit the discretionary space managers.

We try to test the combined effect of governance mechanisms and social status on the level of accruals through the following model:

$AD = f(\text{social score} + \text{governance variables} + \text{control variables})$.

We present the results of this estimate in the following table :

Table 9 : Estimation result

Variables explicatives	Coefficients
MO?	0.003680
INSO?	0.002086
COMP?	-3.68E-10
OUT?	-0.000802
DUA?	-0.004581
TENU?	-0.010088
BS?	0.003421
NMB?	0.024799*
LIT?	0.011652
SC?	0.011558
NMSC?	-0.011441
COD?	0.008898
AGE?	0.004836*

REG?	0.083075
PUBSR?	-0.247851*
S?	-0.026488
ROE?	0.033504
ROA?	0.527504*
D?	-0.030304
SIZE?	-0.000394
FCF?	-0.627030
RD?	0.217312
S?	-0.000415
R-squared	0.589115
D-W	2.213122
F-Stat	2.236532
PF-Stat	0.018616

*, **, *** : Thresholds risk level of 1% , 5% and 10% , respectively.

Where S ? is the social score

The social score with governance mechanisms seem irrelevant to curb accounting manipulations.

Therefore, the status is not a guarantee of right commitment of managers in these companies.

So we can conclude that in sustainable citizens firms, we detect entrenchment strategies and managerial opportunism that go against the interests of social objectives (*Shleifer and Vishny* , 1989).

If their strategies respond to a particular category among stakeholders, their interests must be guaranteed and coupled with this response.

Table 1: list of sustainable citizens firms

Sustainable citizens firms
AUTODESK
NORTHWEST NGCO
ECOLAB
PITNEY
CISCO SYSTEM
STARBUCKS
SOUTHWEST AIRLINES CO
TIMBERLAND
INTEL
HERMANMILLER
CUMMINS

5. Conclusion and recommendations

In this research, we are interested to check, in the context of sustainable citizens firms if governance mechanisms can hamper social commitments. We also tried to detect if they can curb the managerial discretionary.

We found that even if these companies were classified ,for six years of our study,on the lists of the 100 Best Corporate Citizens, this does not imply that they have ideal governance structure.

We found that behind this status, many opportunistic strategies are developed, resulting from the failure of the inefficiency of governance mechanisms.

These mechanisms seem more defend the interests of shareholders at the expense of other partners

It is interesting to note that we found that the company "Intel" , which it is the most powerful social , seems to be the most susceptible to manage results. This discretionary strategy seems to be catalyzed by factors related to the system of governance and more specifically, managerial opportunism.

This is put in question the credibility of Sustainable citizens to be seen as prototypes and blameless companies.

These findings highlight the opportunistic practices even in best companies

In addition, these results highlight another type of entrenchment: social entrenchment. Therefore, the more companies stay exited on the social list, the more it will be prone to opportunistic strategies

Recommendations

We think that the criteria of social ranking should be improved and more précised

Furthermore, they should eliminate financial performance from the criteria base.

More studies should be investigated in this direction to show the degree of credibility of these companies.

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