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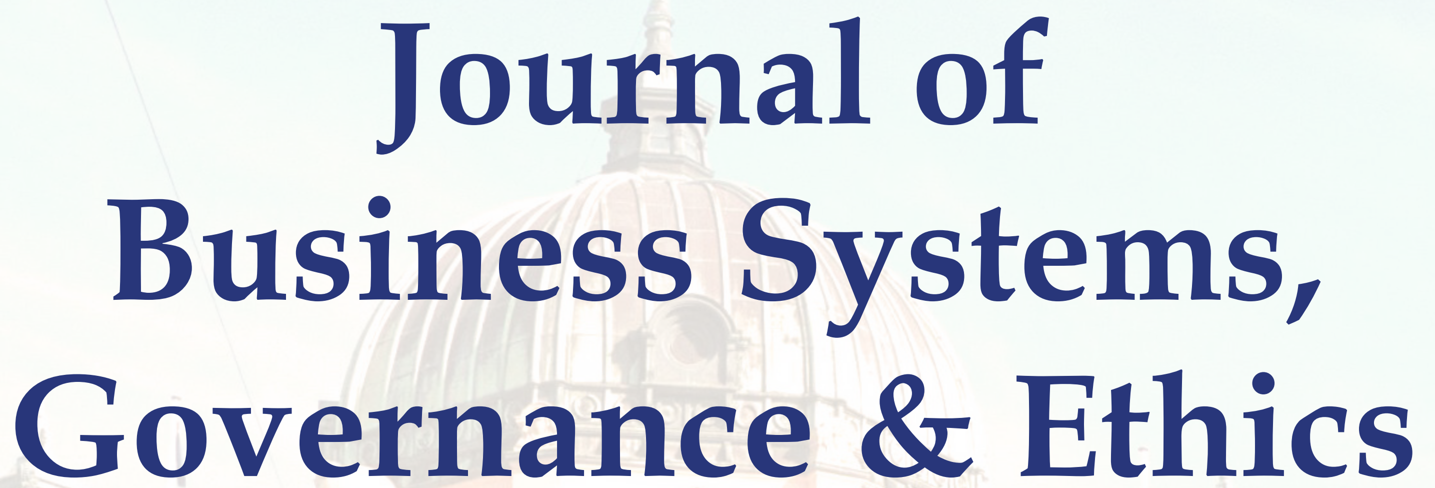

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Editorial

Ethics and Values in the Corporate World

This is the ninth edition of the Journal of Business Systems Governance and Ethics. This edition represents a new chapter in the journal's history as it is the first to be mounted in the new e-system adopted by VU that will eventually house all the Victoria University journals. The system provides not only journal management but also a greater capacity to access papers and interact with our readers.

The JBGE continues to present the unique blend of multidisciplinary research that addresses the complexity of the modern environment and interdependence of the problems of governance, information systems and ethics. This edition is no exception. The first two papers turn to ethical and sustainability issues and the remaining papers are concerned with governance practices in the financial system.

In general, audit committees are seen as the watchdogs of the corporate world with a major role in reporting accountability. Dr. Purcell's study investigated the role of the audit committee in preventing and reporting fraud and corruption in local government in Australia and New Zealand. He found that prevention was dependent on the ethical culture within a Council. Interviews with Councillors produced a diversity of views of the role of audit committees. His conclusions were that most people thought that investigation of fraud and corruption was outside their areas of responsibility.

Robinson and Nikolic also address ethical issues. Their paper proposes a framework for monitoring business performance of sustainability objectives. Their framework is based on criteria that incorporate global, societal, external, industry, organizational, leadership and individual/personal sustainability issues. The framework assumes that corporations will develop strategic objectives and establish priorities that relate to the seven issues. These can be weighted for importance and the level of performance assessed against a 1-10 scale from 'superlative level of accomplishment' to 'totally despicable performance'. The rating can be monitored and compared each year. The authors suggest that the process of setting and rating objectives can be participative and serve to motivate individual within an organisation.

The two final papers in this volume concern the financial industry. Howard argues that the Basel III legislation not only prevents banks from failing but addresses the corporate governance issue highlighted in the agency problem of the divergence of interests between shareholders and management. They argue that the regulatory provisions in Basel III, increasing the amount of equity a bank must contain in relation to its risk-weighted assets and requiring an increase in capital ratios, promote transparency and stability. This serves the interests of all stakeholders as it exposes risk taking by managers and constrains practices such as off balance sheet activities. As a governance measure the regulations reduce risk taking and meet stakeholder objectives for firm wide and systemic stability.

Li et al move away from examining western institutions to those complying with sharia law. The authors describe a systematic meta-analysis of existing studies which examined the relationships between governance mechanisms in Islamic banks and performance. To identify relevant studies the

authors used different strategies. These were: a search of electronic data bases for potential studies, a manual search, confirmation of the studies via Scopus and Google Scholar; and confirming the quality of the relevant studies that could be included against five criteria. The paper then presents the results of the analysis of thirteen hypotheses about the relationships between internal governance mechanisms and performance. The results suggested that Shari'ah governed companies exhibited better performance when they complied with several of the governance principles.

The papers in this volume demonstrate the diversity of publications that are accepted into this peer reviewed journal. With the access to new journal management systems, the Board expects the number of issues to rise and provide new opportunities to make a major contribution to the study of governance and ethics in Australia. To this end, we will be seeking to expand the membership of the Editorial Board and invite readers to take advantage of the opportunity to express their interest in joining the Board.

Professor Anona Armstrong AM
Victoria University

Editor

Corruption and Misconduct: A Behavioural Reflection From Investigative Reports Into Local Government

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Abstract

This paper offers a local government perspective on the behavioural factors which can be the precursors for corruption and misconduct and those factors which can prevent corruption and misconduct. The investigation centred on corruption and misconduct evidenced from local government investigation reports in Australia, New Zealand and the United Kingdom. A corruption and misconduct taxonomy was developed and the role of the audit committee in the oversight of corruption and misconduct allegations in local government was empirically tested. The empirical findings indicated low support for an audit committee managing corruption and misconduct allegations. The qualitative research found that a robust culture of zero tolerance of corruption and misconduct was one of the best ways to keep a council honest.

Keywords

Corruption, misconduct, public sector, Australia, New Zealand, United Kingdom

Background

Local government is the third tier in the Australian federal system: the Commonwealth, six state and two territory governments. The 79 municipal councils in Victoria have annual revenues of $A6.6 billion and combined recurrent and capital expenditures of $A7.6 billion (Municipal Association of Victoria 2013a, 2013b). Governance in local government has similarities to corporate governance (Australian Stock Exchange 2007) but can be complicated by a party political dimension, constituents' 'wants' and any personal agendas of councillors or officers.

Introduction

In this presentation, the terms corruption, fraud and misconduct are clarified. It is noted that the perpetrators of corruption, fraud and misconduct in local government can be internal or external to the council, for example, an individual acting alone, individuals acting within with groups or groups operating against the interests of council.

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Fraud, corruption and misconduct

Transparency International (2012) stated that corruption is 'the abuse of entrusted power for private gain. It hurts every-one who depends on the integrity of people in a position of authority'. One of their main precepts is that corruption flourishes in

secrecy, for which the antidote is transparency. Fraud on the other hand, is an 'intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage' (Auditing and Assurance Standards Board 2011:10). This might seem like a distinction without a difference, but fraud generally pertains to obtaining property by deception or by a financial advantage as well as, the creation and the use of false documents. Corruption and misconduct has a broader remit as local government has discretionary powers within their decision-making processes which can act as an enabler for: bribery; conflict of interest; inappropriate development and planning applications; misuse of council resources; partiality and personal interests in procurement and tendering.

The terms 'corruption' and 'misconduct' can sometimes be used interchangeably for example, Gerasimova (2008:223) described corruption as the exercising of 'legitimate discretion for improper reason' and the Independent Commission Against Corruption (ICAC) (2008:1) defined corruption, and misconduct as 'the dishonest or partial behaviour, misuse of information, or breach of trust by a public sector employee, which if proved could amount to a crime or a disciplinary offence'. ICAC (2008:1) considered that corruption extended to the 'conduct of a person, which adversely affects, or could affect, the exercise of an official function by public officials'. Excluding any personal ramifications associated with an individual's corrupt or misconduct misbehaviours, the implication for councils is that their integrity and reputation can be either impacted by proven corruption or tainted by the perception of corruption. This can result in public confidence, financial loss and poor staff morale. There is a need to better understand what can be the causes of corruption and misconduct in order to find ways to reduce their incidence.

Perpetrators

Whilst corruption and misconduct in local government may be a function of motive, opportunity and rationalisation (Wells 2007:91) from the perpetrators perspective, there can be 'the personality correlates of fraud' (Krambia-Kapardis 2001:42) which she summarised as psychological for example: large ego, low self-control, low self-esteem, lying, lack of anxiety and empathy, indifference of the consequence of one's behaviour and impulsivity, and sociological: 'one's associates being part of a criminogenic corporate culture', the ability to neutralise guilt and being prepared to exploit opportunities (Krambia-Kapardis 2001:42-43). We consider that these antecedent factors can influence or act as 'enablers' (Lewin 1951) for the perpetrators, for example, Robbins (2003) noted the influences of: motivation, personality, emotions, job satisfaction, work stresses and personal stresses. For groups, he suggested the influences of group dynamics, clique behaviours, communication, power, conflict, culture, group processes, decision making and inter group behaviours. The mayor and the chief executive should be conscious of the pervasive nature of a negative organisational culture (Lagan 2005a 2005b) sub-cultures, power, conflict, intra-organisational politics and the party political dimension.

Cost

The KPMG (2013:6) Australian and New Zealand biennial bribery and corruption survey for the years 2010-2012 reported that fraud had cost the respondents at least $A373 million in the last two years increasing from $A105 million in 1997. Whilst it was difficult to quantify the total cost due to undetected and unreported frauds, KPMG (2013:19) reported that the major public sector fraud categories were tendering, cash and payroll with four reported corruption incidents representing 30% by value of all incidents (KPMG 2013:19). They found that the major two reasons for the prevalence

of corruption were the lack of senior management's commitment to ethical conduct and the 'inherently unethical nature of the industry in which the organisation operates' (KPMG 2013:36). Whilst there can be some mechanisms in place to investigate corruption and misconduct for example, the auditor-generals and the anti-corruption bodies, these mechanisms cannot necessarily guarantee that actions within each council will be taken to prevent corruption and misconduct. Prenzler & Faulkner (2010:257) stated that: 'anticorruption commissions in Australia do not have the power to take disciplinary action against holders of public office when they believe disciplinary action is warranted' which was supported by Purcell (2012a:144) who stated that investigative agency reports may not meet the evidentiary hurdle for subsequent criminal prosecutions.

Possible explanations?

In explaining corruption and misconduct we were influenced by Marnet (2008) who considered that the focus should be on managerial behaviours themselves, the behavioural traits of individuals not observing accepted societal norms, the tendency of regulators to concede or acquiesce towards corporate misdeeds and the 'socio-psychological effects of group decision-making on judgement and decision quality' (Marnet 2008:9). The 'correlates of criminal behaviour' (Krambia-Kapardis 2001:43) complemented Marnet (2008:97) who stated that 'individuals vary in degree to which they are susceptible to various bias, self-control problems, and temporal inconsistencies'. He further stated that individuals may not act consistently 'when they face choices under uncertainty and may instead vary in their responses depending on situation, context and mood'.

In relation to group behaviours Marnet (2008:97-156) noted the influences of the nature of bias, belief perseverance, loss aversion, escalation of commitment, group-think, sub-optimal monitoring and adverse risk perceptions. These factors may also contribute to an environment that is conducive to corruption, fraud and misconduct to occur, such that, they are surreptitiously inculcated into individual and group behaviours. We concur with Marnet (2008) that the focus should be on managerial behaviours themselves, the behavioural traits of individuals not observing accepted societal norms, the tendency of regulators to concede or acquiesce towards corporate misdeeds and the 'socio-psychological effects of group decision-making on judgement and decision quality' (Marnet 2008:9). These behavioural corruption and fraud precursor conditions together with the motivations for fraud for example, greed, lifestyle, personal financial pressure, gambling and substance abuse (KPMG: 2013:25) were the catalyst to reflect upon the behavioural antecedents for corruption and misconduct in local government. We were influenced by Friedrichs (1996:241) who considered that all explanations of white collar crime have a basic proposition of aberrant human behaviour and that the 'ultimate complexity and diversity of white collar crime precludes the possibility of any single comprehensive theory or explanatory scheme'. We have taken an organisational behavioural perspective because 'to understand the social embeddedness of deviant and criminal behaviour it is essential to grasp that the business organization is the weapon, the means, the setting, the rationalization, the offender, and the victim' (Punch 1996:214).

We consider that a behavioural perspective can provide a prism through which corruption and misconduct in local government can be more effectively understood (Purcell 2012a, 2012b). We have reflected on corruption and misconduct from an organisational behavioural perspective (Gettler 2005a; Long 2008; Marnet 2008; Punch 1996) as compared to compliance and an individual's perspectives (Friedrichs 1996; Cavaiola & Lavender 2000) and consider that this provides a way of understanding the preconditions for corruption and misconduct to occur.

Literature review

Sampford, et al. (2006:1) considered that corrupt payments can influence public policy choices and decisions by officials. They believed that corruption and misconduct should be investigated, not for the sake of morality, but because society paid the price for corruption in one way or another. Corruption and misconduct can be evaluated from the perspective of official corruption for example, bureaucratic and political corruption and the misuse of public power for pecuniary profit (Gerasimova 2008:224) and occupational fraud (corrupt conduct, asset misappropriation and fraudulent statements) (Association of Certified Fraud Examiners 2010; Wells 2007, 2004).

Aetiology of fraud

Krambia-Kapardis (2001) used the term 'aetiology' of fraud to categorise the source of white-collar crime. Some contributors are detailed in ***Figure 1*** (Krambia-Kapardis, 2001; Weisburd, Waring & Chayet, 2001). Some of the literature had a sociological or psychiatric origins (Clarke 2005; Gottschalk 2010; Griffin & O'Leary-Kelly 2004; Griffin, O'Leary-Kelly & Collins 1998; Kets de Vries 2001, 1991; Punch 1996) although the Association of Fraud Examiners (2010); Wells (2007, 2004) and KPMG (2013, 2010, 2008) provided recent data in relation to the incidence of fraud.

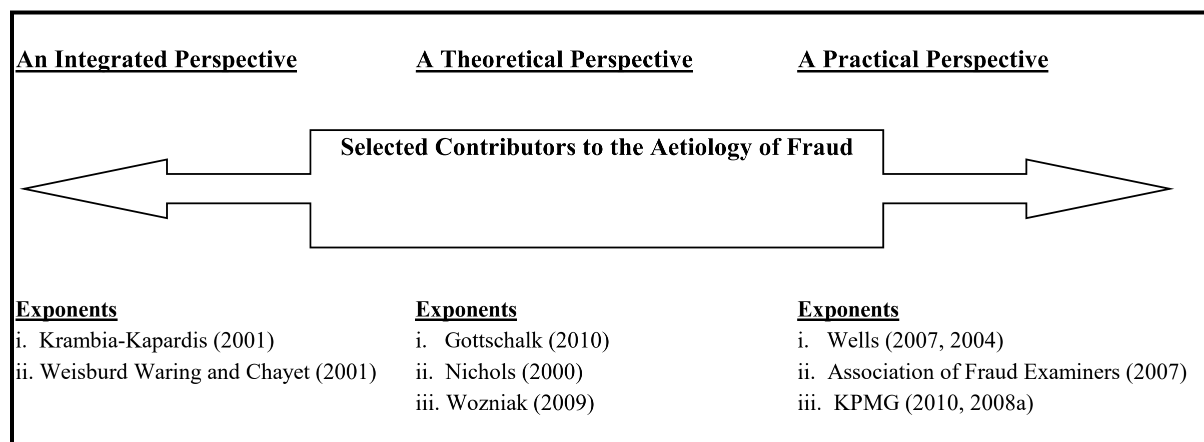

Figure 1 Select contributors to the aetiology of fraud

Krambia-Kapardis (2001) considered that criminal behaviour can be correlated with an offender's personality and situational factors; and these factors can be present in fraud offenders. She considered that it was important for auditors to undertake a comprehensive fraud assessment risk of the companies they audit, based in part on 'red flags' (KPMG 2013:13) and the relationship between 'different industries, different irregularities, different ways that alerted auditors and different audit procedures that appear to detect them' (Krambia-Kapardis 2001:167). Weisburd et al. (2001:3) contradicted the notion that white-collar offenders were generally one-off offenders and noted that offenders had 'multiple contacts in the criminal justice system'. They concluded that repeat offenders presented a mixture of traits associated with deviance and conformity, but as they were white-collar criminals, they had characteristics associated with social stability and achievement.

Gottschalk (2010) provided a synthesis of the prevailing behavioural, organisational and managerial theories associated with criminality. This had some similarities to a meta-analysis, but was more a description of the literature than a critique. Nichols (2000) analysed similarities and differences between the perception of criminologists and management theorists in relation to white-collar crime. He noted that both groups considered white-collar crime to be serious and that both groups had placed an increased emphasis on white-collar crime over the past two decades. Wozniak (2009) examined white-collar crime from the perspective of institutional structures. He argued that there was a tendency in the criminology literature to explain emerging patterns of crime by referring to dysfunctional families or individuals, rather than dysfunctional social structures. From a fraud investigators' perspective, Wells (2007) categorised fraud by topic and types of schemes and the Association of Fraud Examiners (2010) provided an American perspective on the incidence of white-collar crime, while KMPG (2013, 2010, 2008) offered an Australian perspective. Their contribution was the currency of source material obtained from the periodic business surveys: annually for the Association of Fraud Examiners and biennially for KPMG.

<u>Misconduct related factors</u>

Berlinski (2009) stated that corruption was the 'cancer of economics, with all that metaphor implies' and it was 'enigmatic, poorly understood, hydra-headed, deadly and often hidden until it is too late', (Berlinski 2009, p. 81). By way of parallel, Chang and Golden (2007) examined electoral elections in forty democratic countries in the 1990s and concluded that corruption became less severe as elections were more open, whereas corruption increased where there was closed proportional representation and interference in the political processes. Electoral dishonesty is a reputation risk for councils and can contribute to an unethical and illegal culture which can be pervasive. Brimbank City Council (Ombudsman, Victoria 2009a), Greater Dandenong Council (Reilly 2009) and Whitehorse City Council (Bachelard 2009; Lowe 2010) provided a Victorian perspective to Chang and Golden (2007) which related in part to the party-political machinations, alleged vote rigging and alleged interference in the processes of council(s). The alleged inclusion of dummy candidates in the Whitehorse City Council election in 2005 was subsequently dismissed in the County Court in October 2010, (Lowe 2010, Bachelard 2009). Johnson (2008) focused on the relationship between corruption and the democratic process and the ability to disentangle them and stated that corruption was entangled 'in the political, social and economic landscape in which it operates' (Johnson 2008:371). She considered that corruption cannot be addressed in isolation from these conditions and that it had 'a corrosive and widespread effect on the quality of life of its citizenry' (Johnson 2008:372). For the citizens of the City of Port Phillip (Ombudsman, Victoria 2009b) and the City of Ballarat (Inspector of Municipal Administration 2008) Johnson's observations would appear to be prophetic. Given the above observations on the type of environment where it is most likely to occur, it is important to turn our attention to a behavioural perspective of the antecedent conditions for corruption and misconduct to occur.

<u>Behavioural perspective</u>

A behavioural perspective can reflect upon an individual's response to the opportunity to engage in corrupt behaviours and the organisational culture for an individual's behaviour to occur. Andreoli and Lefkowitz (2009) considered that organisations with ethical policies, practices and leaders set a positive example of ethical behaviours which contribute to the environment where misconduct could be predicted. Should there be a change in the environment ethical behaviours may be impacted. We suggest that a positive and ethical culture in a council together with strong adherence to internal

controls increases the ability to detect and prevent corruption, fraud and misconduct, notwithstanding the perpetrators' motives, opportunity and rationalisation. Hodgkinson (1997) examined the changes in the public sector in the 1990s in the United Kingdom in terms of the mode of service delivery and marketization and considered that these were part of the contributing rationale for corruption and misconduct to occur. This was similar to Punch (1996:214), who argued that organisations were the means and the victim, notwithstanding that it was an individual or a group of people who perpetrated corrupt conduct. Hodgkinson (1997:33) considered that the 'marketised public sector' was a state of tension and that it 'creates a hiatus in systems of control and accountability within which the opportunities and incentives for corruption abound'. These tensions in the public sector were also alluded to by Adcroft and Willis (2005); Willis (2004) and Wilson (2003). Hodgkinson (1997) considered that corruption should be examined in the context of systematic or structural corruption explanations similar to the explanations by Punch (1996) and Gobert and Punch (2003).

Punch (1996:213) considered that business was criminogenic and that understanding crime and business 'lies in recognising the structure that the business environment gives to misconduct, both in terms of opportunities, and how misconduct is managed'. He did not believe in a criminological model of fraud and concluded that any attempts to explain fraud 'merely generates platitudinous generalizations' (Punch 1996:244). Gobert and Punch (2003) argued instead for a multi-causal explanation of corruption and misconduct with contingent, situational conditions playing an important role in individual cases. Griffin and O'Leary-Kelly (2004:4) considered organisational dysfunctional behaviour to be 'motivated behaviour by an employee or group of employees that has negative consequences for an individual within the organization, another group of individuals within the organization, or the organisation itself'. Gettler (2005a, 2005b) applied the medical term 'psychoses' in a metaphoric sense to the dysfunctionality of organisations. Gettler (2005b:25) cited Bion (1961) in relation to warning signs from dysfunctional groups and stated that Finkelstein (2003) validated the patterns of destructive behaviour in his study of corporate collapses:

Clarke (2005) considered that a fraudster may not necessarily be a sociopath and jumping to such conclusions cannot be substantiated without evidentiary based practice. O'Malley (2002) and Friedrichs (1996) affirmed the conclusions of Sutherland (1961), that is, psychobiological and pathological explanations for white-collar crime have generally been excluded by criminologists as an explanation for white-collar crime. O'Malley (2002:2) argued 'those criminals are people whose environment provide an excess of definitions favourable to crime' which affirmed the argument of Clarke (2005:114). The interpretations of O'Malley (2002), Friedrichs (1996) and Clarke (2005) accorded with Coleman (1994:361), who considered that the motivation and opportunity for white-collar crime to occur are 'separately interwoven and any successful theory of white-collar crime must take that fact into account'. Price (2000:177) supported Coleman (1994) in relation to ethical failures and stated that in relation to ethical failures of leadership, 'we are often disposed to look for an explanation of the leader's behaviour, not an analysis of the moral status of what was done'.

The Institute of Internal Auditors and KPMG Fraud Survey (KPMG 2008:20) used the term, 'red flags', which are 'early warning signs of possible fraud'. Krambia-Kapardis (2001:51) considered that a disadvantage of a 'red flag' was that it focused attention on cues and potentially limited an investigator from observing other conditions. Clarke (2005:77-101) expanded the notion of 'organisational indicators to include pathological behaviours by a manager or staff member, for example, manipulative, unethical, shallow and parasitic actions, staff bullying and a desire for power and control'. The KPMG Fraud Survey (KPMG 2013:30, 2008:20) noted that 21%-22% of respondents in the two surveys indicated that the warning signs of fraudulent activity (KPMG 2013:13) were ignored.

Corruption and misconduct generally requires two or more parties to consummate the act, for example, councillors using their positions to promote their interests or the interests of other parties (Inspector of Municipal Administration 2008) and usurping planning delegations (Inspector of Municipal Administration 2006; Ombudsman, Victoria 2007). Even when corruption and misconduct can be identified, it is difficult to have a clear picture. Perry (2001:7) noted that one should be careful in trying to estimate the levels of corruption and misconduct in Australia, because the data pertaining to corruption and misconduct via the courts was 'quantitatively uncertain, and qualitatively an imperfect part of the totality'. Andreoli and Lefkowitz (2009:311) noted the limitations of empirical research namely: most of the research was non-quantitative; it is difficult to obtain measures of illegal activities unlikely to be observed by others; and corruption was not amendable to accurate self-reporting.

Method

The research was undertaken in three parts namely: (1) a review of local government investigation reports in Australia, New Zealand and United Kingdom which were used to formulate a taxonomy of corruption and misconduct; (2) quantitative research formulated from the research question: *Do the investigations into local government maladministration and malfeasance enhance governance and the audit committee's effectiveness?* and (3) qualitative research.

In the period of 1 January 2000 to 30 September 2009 there were 20 inquiries and investigations into Victorian councils by the: Auditor-General, Victoria, (three investigations); Local Government Victoria, (eight investigations); and Ombudsman, Victoria, (nine investigations) (***Table 1***). Twenty inquiries, in nearly 10 years in 79 councils is a small number, and we reviewed another 64 local government inquiry reports from New South Wales, Queensland, Western Australia, New Zealand and United Kingdom as a further point of reference and comparison and to increase the number of councils being studied (***Table 1).***

Table 1 Investigation Reports into Local Government in the Period 2000 – 2009

State	Investigation Agency	Number
Victoria	• Auditor-General, Victoria • Local Government Victoria, (Department of Planning and Community Development) • Ombudsman, Victoria	3 (Note 1) 8 9
New South Wales	• Department of Local Government, New South Wales • ICAC	10 13
Queensland	• Local Government, Queensland • Crime and Misconduct Commission	1 9 (Note 2)
Western Australia	• Department of Local Government and Regional Development • Corruption and Crime Commission	4 4 (Note 3)
New Zealand	• Controller and Auditor-General New Zealand	6
United Kingdom	• Audit Commission, United Kingdom	17
	Total Number of Reports	**84**

From reports from the Auditor-General, Victoria, Local Government Victoria, Ombudsman, Victoria, Department of Local

Government, New South Wales, ICAC, New South Wales Local Government, Queensland, Crime and Misconduct Commission,

Queensland, Department of Local Government and Regional Development, Western Australia, Corruption and Crime Commission

Western Australia, Controller and Auditor-General New Zealand and Audit Commission, United Kingdom.

Notes:

Note 1: The reported number of investigation reports has excluded consideration of the financial and performance in local government.
Note 2: The Crime and Misconduct Commission was established in 1991, and since 2000 has undertaken 9 investigations into local government.
Note 3: The Corruption and Crime Commission was established in 2004.

This number was reduced to forty-six reports selected on the basis of: similarities in the ambit of the council's responsibilities; and the availability of investigation reports to complement the corruption and misconduct taxonomy developed in this research. The research questionnaire was based on a 'factorial design' to measure the perceptions of Victorian mayors, chief executives and chairs of the audit committee with the results compared with the perceptions of the committee members of the Local Government Shires Association of New South Wales (LGSANSW) and board members of the Municipal Association of Victoria (MAV). A response rate of 36% from 282 questionnaires provided the quantitative data to compare and contrast results from councils. Following the quantitative research, interviews were held with a mayor, a councillor, two chief executives, two directors of corporate services, an auditor and three chairs of audit committees to explore the low response rate to some questions from the quantitative research and the relevance of research outcomes for their councils.

Findings

The review of the local government investigation reports from Australia, New Zealand and the United Kingdom provided examples of corruption and misconduct, but did not fully explain the behavioural reasons that allowed the fraud, corruption and misconduct incidents to occur. The investigation reports detailed in ***Table 2*** and ***Appendix 1*** can be interpreted within the following taxonomy developed in this research, namely: council maladministration, financial mismanagement, corrupt or unethical conduct by councillors or staff and breaches of statutory powers. Breaches of statutory powers in planning powers also can include political interference by councillors, politicians and self-interested parties.

Table 2 Summary of Local Government Investigations in Victoria, New South Wales, Queensland, Western Australia, New Zealand, and the United Kingdom

Category	**Victoria (Note 1)**	**New South Wales, Queensland and Western Australia (Note 2)**	**New Zealand and United Kingdom (Note 3)**	**Sub-Total**
Council governance and maladministration	2	2	6	10
Financial mismanagement	3	3	5	11
Corrupt or unethical conduct by councillors or staff	4	14	2	20
Breach of statutory powers	4	nil	1	5
Sub-Totals	13	19	14	46

Note 1: For Victoria, the investigations reports are from the Auditor-General, Ombudsman, Victoria, and the Inspector of Municipal Administration.

Note 2: For local government in New South Wales, Queensland, Western Australia, the investigation reports from the ICAC, Crime and Misconduct Commission, Corruption and Crime Commission and the Department of Local Government.

Note 3: The investigation reports from New Zealand and the United Kingdom are from the Audit-Commission, United Kingdom and the Controller and Auditor-General, New Zealand respectively.

This presentation in ***Appendix 1*** and ***Table 2*** does not suggest that all councils are corrupt, engage in systemic misconduct, or even that the allegations in the investigation reports are proven within a subsequent judicial review process. For example the: (1) allegations into the financial management practices in the Warrnambool City Council (Auditor-General, Victoria 2005); (2) allegations of misconduct in the Douglas Shire Council (Crime and Misconduct Commission (2006), and (3) the funding of a proposed stadium by the Dunedin City Council and the Otago Regional Council (Controller and Auditor-General, New Zealand 2007) were found to be unsubstantiated. Nevertheless, there are some inherent corruption and misconduct risks in local government for example, statutory planning and building control, which stakeholders need to be cognisant of, including the offering and the solicitation of bribes. ***Table 2*** and ***Appendix 1*** provides examples of behaviours in local government which can be perpetrated by councillors, the leadership team of council, employees against the council interests, external parties or a combination of these groups. The relevance of the taxonomy of corruption and misconduct is that it identifies areas of known high risks (***Table 2***) which can assist councils to effectively focus their attention on preventing and detecting corruption and misconduct to safeguard councils against future incidents. The taxonomy complements the corruption resistance strategies in local government (ICAC 2001) and public sector fraud (KPMG 2013).

The empirical research in relation to the question whether investigations into *local government maladministration and malfeasance enhance governance and the audit committee's effectiveness* was not supported. The mayors, chief executives and chairs of audit committees of Victorian councils were more satisfied with the existing processes for the management of corruption and misconduct policies than their counterparts the LGSANSW. The responses from board members of the MAV were low in comparison to the LGSANSW and there was a wide range in the standard deviation reflecting a diverse range of views from the mayors, chief executives, chairs, committee members of LGSANSW and the MAV board members. The respondents did not consider that the audit committee was the appropriate forum to receive allegations. Whilst Victorian councils were cognisant of their misconduct and corruption risks and had generally benchmarked their management processes against the internal control deficiencies from the investigative reports, there was no support for an audit committee to actively participate in or oversee whistle-blower or misconduct allegations.

From the qualitative research, the interviewees did not consider that the audit committee had a role to play in the oversight of misconduct or whistleblower allegations. One councillor noted that these matters were generally handled directly by the chief executive or independently by an external investigative agency. One chief executive indicated that if there was an important issue, he would immediately inform the mayor and chair of the audit committee and the councillors and the audit committee at their next meeting. An audit committee chair referred to the council's fraud and

misconduct policy, and considered that the audit committee would be part of the communication chain albeit, not part of the management or investigative process. He indicated that if the allegations related to the chief executive or a councillor, the audit committee chair may be a conduit to provide oversight of the process although any councillor's misconduct would normally be subject to the processes of a councillor conduct panel under sections 81A–81S of the *Local Government Act (1989)*. A corporate services director stated that having a role for the audit committee in any investigative process could confuse the role of the audit committee as compared to providing oversight of the council's risk management processes. Another corporate services director discussed the inherent corruption and misconduct risks of councils, which can be hidden beneath the surface. He believed that a robust culture within council was one of the best ways of expressing a zero tolerance to corruption and misconduct and provided a safe environment for any issues to be raised. He considered that it was not the role of the audit committee to either investigate or manage the allegations. Another chief executive concurred with these observations and stated that it was always a question of prudence, of where the line was drawn, between advising the audit committee and overburdening the audit committee.

Discussion

So what do the outcomes from the investigative reports and the empirical research mean for local government? Corruption and misconduct in local government can be a complex and multifaceted phenomenon and no single theory can comprehensively explain all forms of misconduct within the aetiology of fraud. In explaining misconduct in local government one needs to recognise human behaviours in all their intricacies and varieties. Friedrichs (1996:241) stated that 'the ultimate complexity and diversity of white collar crime precludes the possibility of a single comprehensive theory of explanatory scheme'.

One needs to reflect on the levels of theory for example: Krambia-Kapardis (2001), Gottschalk (2010) Nichols (2000), and Wozniak (2009) with the fraud practitioners' perspective (Wells 2007; KPMG 2013, 2010, 2008) as compared to explanations for corruption & misconduct (Punch, 1996; Griffin & O'Leary-Kelly, 2004; and Clarke 2005). Whilst greed can be a core motivation to explain corruption and misconduct, the antecedent behavioural conditions for corruption and misconduct to occur and in what circumstances, can be multiple. Overwhelmingly it will be specific to each council in which the corruption and misconduct event occurs. For example, a council could have an over-controlling leader, staff with passive-aggressive personalities, staff with narcissistic or histrionic personality disorders or other behavioural traits. A practical approach to solving a myriad of organisational problems based on personality traits can be difficult, due in part to their complexity and potentially their interrelationship with other internal and external influences (Clarke 2005). In relation to dysfunctional behaviours in organisations, behaviours and emotions within an organisation can coexist on a number of levels, namely the individual, the group; the council, as well as compliance and stakeholder interactions (Robbins 2003). Organisational dysfunctionality can relate to the toxicity of culture and low emotional intelligence on the part of the leader; however, a consequence of dysfunctionality is its impact upon followers in the organisation (Clarke 2005; Griffin & O'Leary-Kelly 2004; Griffin, O'Leary-Kelly & Collins 1998; Pech & Slade 2004; Robbins 2003).

Applying some psychological theories to corrupt or dishonest organisations and disgraced leaders retrospectively was simple, yet it was generally impossible whilst an organisation was in the midst of a crisis (Clarke 2005; Gettler 2005b; Griffin & O'Leary-Kelly 2004; Griffin et al. 1998; Kets de Vries 2001, 1991). Some staff within councils may have limited insights and may have observed various unrelated incidents, but these events and behaviours may not be in context. Even if some staff can

clearly identify the issues, they may be powerless to influence or implement changes. Whilst it may be possible to generalise about councils sliding into an abyss, it is quite another thing to build a model that accurately predicts council corruption. However, the investigation reports of local government within Australia, namely in New South Wales, Queensland, Victoria, and Western Australia, and abroad, New Zealand and the United Kingdom have been accepted as validating findings of corruption and misconduct, notwithstanding that only a court can determine if the parties involved are guilty or not guilty.

In relation to governance Marnet (2008, 2007, 2005, 2004) considered that some of the literature focused on a quantifiable relationship between measures of corporate performance and solutions to agency problems such as independent directors, external audits and accounting standards. This raises questions about the effectiveness of the conventional approach to monitoring and controlling the behaviours of managers. Marnet (2008) considered that whilst the research had identified some important aspects of the fundamental conflict and tensions between agent and principal, there were some questions as to the relevance of the research in monitoring and controlling managerial performance. He noted that 'numeric variables and models of rational behaviour have a poor record in the detection, prevention, and forecasting of earnings management, and accounting fraud' (Marnet 2008:207).

An outcome from this research and an area of future research relates to the power of culture and subcultures within a council, which can have the ability to hide more than it reveals. Lagan (2005a, 2005b) considered that in its simplest form organisational culture is a set of societal arrangements that needs to be consciously managed, rather than left to chance. This suggests that a culture of a council can cast long shadows that may conceal unspoken and deeply pervasive irregularities, as identified from the investigation reports. These shadows can become manipulated systems with councillors and executives slowly coming adrift from peer and industry norms and this pathological drift may desensitise councillors and executives to the severity of irregularities and its destructive nature within a council.

Conclusion

What emerges from the review of the investigative reports is that explaining corruption and misconduct in local government can be difficult. To investigate them requires the trust of informants and the ability to have powerful insights with impeccable timing. All this is not possible without the support of councillors and the chief executive, who may or may not be disposed to someone analysing corruption and misconduct risks, particularly if they are not as 'white as snow' themselves. Whilst agency reports are a point of reference to identify corruption or misconduct, there may have been some earlier anecdotal evidence or suspicions of wrongdoing, notwithstanding it may not have met the evidentiary hurdle for a successful criminal prosecution. Also, it can be difficult to identify corruption or misconduct when events are happening within various work groups and subcultures within council.

Thus the investigation reports in local government councils can be partially explained in the broader behavioural context of organisational dysfunctionality, a toxicity of culture, ineffectual leadership and an individuals' unethical response to opportunity and motivation to engage in corruption and misconduct.

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Appendix 1 Investigation reports in to local government

This appendix lists the investigations into local government, namely: (1) Victoria; (2) New South Wales, Queensland and Western Australia; and (3) New Zealand and the United Kingdom.

i. Local government investigations, Victoria

Name of Report	Reference
Council governance maladministration	
Report of Investigation into Glen Eira City Council	Inspector of Municipal Administration (2005)
Investigation into the Conduct of Council Officers in the Administration of the Shire of Melton	Ombudsman, Victoria (2005)
Financial mismanagement	
East Gippsland Shire Council: Proposed sale of Lakes Entrance property	Auditor-General Victoria (2005)
Investigation into Surf Coast Shire Council	Inspector of Municipal Administration (2002)
Review of Warrnambool City Council Financial Management Practices	Auditor-General, Victoria (2005)

Unethical or corrupt conduct by councillors or staff	
Investigation into Ballarat City Council	Inspector of Municipal Administration (2008)
Investigation into the alleged improper conduct of Councillors at Brimbank Council	Ombudsman, Victoria (2009);
Report on Brimbank City Council	Inspector of Municipal Administration (2009)
A Report of Investigations in the City of Port Phillip	Ombudsman, Victoria (2009)
Breaches of statutory powers	
Community Planning Services in Glenelg Shire Council: 1998-2005	Auditor-General Victoria (2005)
Report on Investigation into Greater Geelong City Council	Inspector of Municipal Administration (2006)
Investigation into corporate governance at Moorabool Shire Council	Ombudsman, Victoria (2009)
Own Motion Investigation into the Policies and Procedures of the Planning Department at the City of Greater Geelong	Ombudsman, Victoria (2007)

ii. Local government investigations, New South Wales, Queensland and Western Australia

New South Wales

Name of Report	Reference
Council governance or maladministration	
Brewarrina Shire Council Public Inquiry	Department of Local Government (2005)
Broken Hill City Council Public Inquiry	Department of Local Government (2006)
Financial mismanagement	
Port Macquarie-Hastings Council Public Inquiry	Department of Local Government (2008)
Liverpool City Council Public Inquiry	Department of Local Government (2004)
Rylstone Shire Council Public Inquiry	Department of Local Government (2004)
Unethical or corrupt conduct by councillors or Staff	
Attempts to improperly influence a Ku-ring-gai Council Officer.	Independent Commission Against Corruption (2009)
Bankstown and Strathfield Councils – Corrupt Manipulation of Contract Procurement Procedures.	Independent Commission Against Corruption (2007)

Unethical or corrupt conduct by councillors or Staff	
Investigation into attempts to improperly influence Warringah Council Officers.	Independent Commission Against Corruption (2009)
Report on Investigation into Allegations of Bribery Relating to Wollongong City Council.	Independent Commission Against Corruption (2007)
Report on the Investigation into Corruption Allegations affecting Wollongong City Council – Part 3.	Independent Commission Against Corruption (2008)
Report on the Investigation into Corruption Allegations affecting Wollongong City Council – Part 2.	Independent Commission Against Corruption (2008)
Report on the Investigation into Corruption Allegations affecting Wollongong City Council – Part 1.	Independent Commission Against Corruption (2008)
Report on investigation into Certain Transactions of Koompahtoo Local Aboriginal Land Council.	Independent Commission Against Corruption (2005)
Report on investigation into Aboriginal Land Councils in New South Wales.	Independent Commission Against Corruption (2000)

Queensland

Name of Report	**Reference**
Investigation into the Allegations Affecting the Douglas Shire Council.	Crime and Misconduct Commission (2006)
Independence, Influence and Integrity in Local Government: A CMC Inquiry into the 2004 Gold Coast Council Election.	Crime and Misconduct Commission (2006)

Western Australia

Name of Report	Reference
Report on the Investigation of the alleged public sector misconduct linked to the Smiths Beach Development at Yallingup	Corruption and Crime Commission (2007)
Supplementary Report on the Investigation of the alleged public sector misconduct linked to the Smiths Beach Development at Yallingup	Corruption and Crime Commission (2009)
Report on the Investigation of alleged misconduct concerning Mr Stephen Lee, Mayor of the City of Cockburn	Corruption and Crime Commission (2008)

iii. Local government investigations, New Zealand and the United Kingdom

United Kingdom

Name of Report	Reference
Council governance or maladministration	
Bude Stratton Town Council - Unlawful Payments	Audit-Commission, United Kingdom (2007)
Chipping Campden Town Council - Financial Governance	Audit-Commission, United Kingdom (2007)
Doncaster Metropolitan Borough Council – Governance.	Audit-Commission, United Kingdom (2008)

New Zealand

Name of Report	Reference
Inquiry into Dunedin City Council and Otago Regional Council's funding of the proposed stadium.	Controller and Auditor-General, New Zealand (2007)
Inquiry into the West Coast Development Trust.	Controller and Auditor-General, New Zealand (2008)
Taupo District Council - Funding of the Interim Establishment Board and the Lake Taupo Development Trust.	Controller and Auditor-General, New Zealand (2002)

United Kingdom

Financial mismanagement	
City of Bradford Metropolitan District Council - Procurement Processes of an Asset Management Project	Audit-Commission, United Kingdom (2006b)
Epworth Town Council - Financial Governance	Audit-Commission, United Kingdom (2008b)
Leicester City Council - Housing Repairs Contracts	Audit-Commission, United Kingdom (2007)
Marlborough Town Council - Procurement of Commemorative Brochure for Royal Charter Celebrations	Audit-Commission, United Kingdom (2005)
North East Lincolnshire Council - Icelandic investments	Audit-Commission, United Kingdom (2009)

Unethical or corrupt conduct by councillors or staff	
City of Westminster Council - Homes for Votes.	Audit-Commission, United Kingdom (2007)
Nottingham City Council - Housing Services.	Audit-Commission, United Kingdom (2009)
Breaches of statutory powers	
Restormel Borough Council - Planning Decisions.	Audit-Commission, United Kingdom (2006)

A Stairway to the Stars: Monitoring Sustainability Performance in SMBs

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Abstract

This article proposes a framework that can be used, or modified for use, as a mechanism to measure, evaluate and monitor progress in business sustainability. It draws upon previous change management models, such as 'Management by Objectives' (Lynch, 1977; Felix and Riggs, 1983) and 'Balanced Scorecard' (Kaplan and Norton, 1995), proposing a conceptual framework for the monitoring of business sustainability. The framework allows sustainability improvement to be monitored by means of a composite sustainability index derived from specific metrics appropriate to a range of prioritised strategic objectives. It then discusses the necessity for such a mechanism to be sufficiently robust in respect of seven contextual issues. It recommends that a firm's choice of sustainability performance measures and their relative priorities should be aligned with global, societal, external, industry, organisational, leadership and individual-personal contexts.

Keywords

Business sustainability, performance-monitoring

Introduction

"Tell me how you'll measure me; and I'll tell you how I'll behave" (Eli Goldratt)

Why is there tardiness among business leaders to give priority to sustainability? This paper assumes one of the reasons may be the absence of a sustainability performance monitoring mechanism in firms. What form should such a mechanism take and how can we be confident that it would induce the changes needed to influence businesses worldwide toward continued sustainability improvement?

Before exploring these questions it is necessary that we define what is meant by business sustainability. As a foundation the World Council for Economic Development definition of sustainable development has been adopted, i.e. development which "meets the needs of the present without compromising the ability of future generations to meet their own needs." (United Nations Brundtland Report, 1987). Whilst we accept that all businesses must operate within the broad scope of global sustainable development, we also believe it is necessary to include the aspect of resiliency, which in essence refers to the firm's ability, whilst striving for economic success, to adapt to external forces over which it has little or no control, and to play a role in the continuation of the ecosystem that sustains it.

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Any framework that purports to facilitate the monitoring of sustainability performance will of necessity be sufficiently robust to be applied across industries and cultures. The framework incorporates contextual issues drawn from the work of Early (1997) and others, namely global, societal, external, industry, organizational, leadership, and individual/personal.

The Seven Contextual Issues

These contextual issues are seen as concentric circles, the outermost circle being the global context, and the innermost being the individual or personal context. The seminal theories within each of these contextual planes will be well-known to scholars of leadership, change management and business strategy, so they are listed only briefly below. More attention will be paid later in this article to each of these areas of concern to sustainability leaders, to the extent that each relates to our proposed business sustainability monitoring framework.

1. Global context – i.e. the current systemic global ‘shocks’, including global warming, global financial crisis, carbon emissions, world poverty, over-population.
2. Societal context – e.g. tightness (Witkin and Berry, 1975), collectivism (Parsons and Shills, 1951), power distance (Hofstede, 1991), judgement (guilt or shame) (Earley, 1997), orientation (Hofstede, 1980), relationship to nature (Kluckohn and Strodtbeck, 1961)
3. External context: the political, economic, social, technological, environmental, legal and ethical issues that can impact business performance and sustainability.
4. Industry context, i.e. industry lifecycle, competitive rivalry, supply-side economics, demand-side dynamics, substitute products and innovation (Porter, 2007).
5. Organizational context, including the physical, financial and technical resource base (said to provide short-term competitive advantage) as well as reputation, intellectual property and competencies such as governance structure, culture, rules and processes (essential for longer-term competitive advantage), (Barney, 2001). Financial considerations include budgetary constraints, investment, and expected returns. Intellectual Property includes innovation propensity, such as development and/or adoption of IT solutions. Technical aspects and current trends, such as electronic and audio-visual processes replacing face-to-face contact
6. Leadership context: Of particular importance to this paper is the ability of the business leader to create a ‘vortex’ that ‘sucks in’ participants. As such it focuses on the leadership styles known as ethical (Brown and Trevino, 2006), authentic (Bass and Avolio, 1993), charismatic (House, 2006), and transformational (Podsakoff, et. al., 1990).
7. Individual/Personal context: Whilst this paper does not purport to include personal psychological concepts, the necessity for business leaders to understand how some common problem areas pertaining to individual choices and personal commitment are important to ensure that any performance monitoring system takes account thereof. In this paper the following aspects are discussed: Self-concept regulation (Erez and Earley, 1993), self-identity (Hinkle and Brown, 1990), goal attainment (Locke and Latham, 1990), role expectations, specifically ambiguity (Katz and Kahn, 1978), entrepreneurial dilemmas (Robinson, Davidson, van der Mescht and Court, 2007), and career advancement considerations (Tajfel, 1978).

Introducing the proposed model

Based on the theoretical and applied knowledge available to them, the authors now proceed to propose a model that will be sufficiently flexible to incorporate the sustainability objectives specific to any small or medium business as well as to prioritize those and measure the firm’s performance at regular intervals. The prioritization is achieved by assigning a relative weighting to each sustainability objective. The measurement of progress towards each objective is facilitated by the designation of metrics corresponding to particular levels of performance. The proposed model is illustrated by means of a worked example in the table below:

Level accomplished		Prioritized Strategic Objectives (SOs)			
		SO 1 = e.g. recycle 60% of solid waste	SO 2 = e.g. reduce carbon emissions by 15%	SO 3 = e.g. switch to 50% renewable energy sources	SO 4 = e.g. reduce fresh water consumption by 60%
Weighting /10:		*1.5*	*4.0*	*3.0*	*1.5*
Superlative level of accomplishment	10	60%	15%	50%	60%
Distinctive improvement	9	50%	14%	45%	54%
Creditable improvement	8	40%	13%	40%	48%
Significant improvement	7	30%	12%	35%	42%
Acceptable improvement	6	20%	11%	28%	36%
No improvement	5	10%	10%	22%	30%
A little worse than last year	4	9%	9%	16%	24%
Unacceptably worse than last year	3	8%	8%	12%	18%
Highly unacceptable	2	7%	7%	8%	12%
Inexcusably poor performance	1	6%	6%	4%	6%
Totally despicable performance	0	Less than 5%	Less than 5%	0%	0%

Table 1: A Conceptual Framework for the Monitoring of Business Sustainability

Notes pertaining to the ‘metrics’ given as examples in the above table:
Weighting: the relative importance of each strategic objective *vis-à-vis* the others, collectively totaling 10.
Level 10: performance consistent with the best in the world, country, or industry
Level 5: as per end of previous year’s level of accomplishment
Level 1: performance is no better than the worst in the world, country, or industry
Level 0: performance is worse than the worst in the world, country, or industry
Levels 6 to 10: the ‘carrot’ - recognition, reward, career advancements ensue
Levels 2 to 4: the ‘stick’ – below this line means we have gone backwards since the previous year

The proposed sustainability management framework is designed to accommodate various necessary components of an effective performance management tool. Strategic objectives should be specific, with a realistic expectation of accomplishment, and designated accountability for achievement within the forthcoming year. The strategic objectives should be linked directly with the business strategies. A maximum of five strategic objectives per year is recommended. Each of these heads one column, which may be weighted according to strategic objective’s relative importance in that particular year.

The total of the weights must be 10. Priorities may be re-established each year in line with the company's strategic plan. This means that some of the objectives may be replaced by measures considered more appropriate to the firm's current stage of development and may be allotted higher or lower priorities by varying their respective weighting. Each of the selected objectives is supported by a finite measurement, or 'metric'. Accountability for each of these outcomes may be allocated to a functional area of the business, or a sustainability project manager and the relevant cross-functional team.

The performance levels are depicted on the vertical axis. A ten point scale is forged in the following way: Level 10 represents the superlative performance, i.e. the current best-in-world or industry, so called 'state of the art'. Level 5 represents the company's current level of performance. Levels 6 to 9 are calculated so as to represent the intermediate graduations spanning levels 5 and 10 in equal steps. Level 0 would be regarded as 'disgraceful', or akin to the worst imaginable performance. Levels 1 to 4 inclusive are calculated, again as equivalent graduated steps between 0 and 5.
The company's overall sustainability performance is measured by monitoring the actual metric within each strategic objective (column), then locating its corresponding 'level'. Finally, for each column, the performance 'level' is multiplied by the respective weight, and the resultant composites added together to give an overall sustainability percentage.

Performance evaluation can be facilitated as follows: In the overall result, if the company has performed above 50%, there is net improvement over the previous year. Conversely, if the overall result is less than 50%, the company's sustainability performance has diminished relative to the previous year. Specifically, if any particular column scored a level below 5, then the company has reduced sustainability in that strategic area. Most importantly, improved performances are evident as their column scores will be greater than 5. Appropriate and culturally-aligned incentives, rewards and disincentives may be applied based directly on these results. The levels may be recalibrated annually, such that the most recent year's performance in each of the strategic objective's metrics is placed at level 5. More dramatic adjustments to the framework can be brought about by rethinking the strategic objectives, or by introducing alternative metrics where needed.

Adoption of sustainability monitoring into the company culture will occur as the monitoring and evaluation process is repeated, the results reported, and the corresponding rewards and punishments are seen to be taken into account when job promotions, incentives, and investment decisions are considered

By way of illustration, let us suppose that our firm achieves the following results in the current year:

SO 1 recycling of solid waste Goal 60% weight 1.5 result 30% = level 7 contribution: 7x 1.5 = 10.5	SO 2 = Reduction in carbon emissions Goal15% weight 4.0 result 11% = level 6 contribution: 6x 4.0 = 24.0	SO 3 = Energy sources Goal 50%renewable weight 3.0 result 40% = level 8 contribution: 8x 3.0 = 24.0	SO 4 = Reduce fresh water usage by 60% weight 1.5 result 36% = level 6 contribution: 6x 1.5 = 9.0	**Overall Sustainability Performance** Composite Score 67.5%

The firm's overall sustainability index is 67.5% for the current year, which represents an improvement upon the previous year (i.e. 67.5/50, as the previous year's score would have been 50% after recalibration). For the forthcoming year, the strategic objectives may be changed, the metric could be altered, or at the very least the levels would be adjusted by recalibrating the existing metrics so that the most recent year's results are portrayed at level five.

Now that the mechanism is explained, we turn our attention to ensuring that the proposed framework is sufficiently robust to adequately facilitate the adoption of all seven of the relevant contextual issues, as listed earlier in the article. These will be discussed one at a time.

1. Global context

Economies around the globe, beset by the aftermath of a global financial crisis, face severe constraints on financial performance. Perhaps an over-emphasis on financial performance has been a contributing factor to the lack of commitment to long-term business sustainability. Business leaders are now faced with the prospect of adopting a more balanced approach to the measurement and evaluation of business performance.

The spotlight has turned in recent years to carbon emissions, which have reached alarming proportions across industrialised regions of the world. It is widely believed that carbon emissions are directly correlated with global warming, though some may contest the cause and effect model (Heimann & Reichstein, 2008). One proposed 'solution' is a carbon emissions taxation, perhaps a globally centralised system, which may unite the world through a common 'currency' and a singular measurement system with a financial effect on businesses, thereby ensuring that at least one aspect of global sustainability becomes a standard item at every board meeting (Roy, Kerry & Kip, 1995).

Outside of the realm of most businesses, other pertinent global issues include over-population and poverty, as well as deforestation and species extinction. Any business that impacts those issues would do well to also include improvement targets in its sustainability evaluation model. Potentially, one of the following strategic objectives in the global context could be selected by a firm: decrease in carbon emissions (targeted percentages listed in the ten point scale), renewable energy consumption (e.g. percentage of total energy consumption), number of approved projects (or annual amount invested) to improve the company's contribution in the realm of environmental sustainability.

2. Societal context

The societal context is discussed under six sections, each referring to a key and well-established construct, namely tightness, collectivism, power distance, judgement, orientation and relationship to nature.

Tightness

Tightness refers to the extent to which rules and norms are present and enforced within a given society (Witkin and Berry, 1975). This is a relevant construct in the context of sustainability as a tight culture would be more conducive to the central control of individual actions (Glenn and Glenn, 1981); Triandis, 1989) as individuals are expected to conform and 'psychological differentiation' is discouraged (Witkin and Goodenough, 1977). Conversely, a 'loose' culture would require a more decentralised approach. For that reason, a sustainability performance monitoring framework must remain flexible and adaptable.

Collectivism

Collectivism, a term made popular by Hofstede (1980, 1991), was first conceptualised much earlier as the tendency of some cultures to pursue collective interests in preference to individual interests (Parsons and Shils, 1951). Within such a culture it is incumbent upon the individual to find favour with peers, even to the extent that an individual's self-image may be dependent on their perceived degree of acceptance by the 'in-group', a concept first explored by Social Identity Theory (Tajfel et. al., 1971). Three levels of self-categorisation were identified, in which the super-ordinate level applies

to the common features one shares with fellow humans (Tajfel, 1978). In the context of sustainability this is highly relevant, as we are seeking to create a new cognitive system in which sustainability issues will need to become the focus of in-group activity.

Power distance

Power distance refers to the degree of inequality, or relative distribution of power, in a given society (Hofstede, 1991) The construct actually 'captures the degree of acceptability of power differentials' (Earley, 1997: 28), which in turn creates perceived legitimacy among so-called powerful individuals who exert influence on the actions of others. The power-distance construct has relevance to the sustainability monitoring process in ways similar to 'tightness' in that it impacts the extent to which employees, teams and particularly those employed in managerial roles within a given business may be willing to accept the dictates of senior executives with regard to the setting of sustainability management targets and monitoring mechanisms.

Judgement

The nature of people's relationship to their own moral commitment was first studied by Mead (1928) as a so-called 'guilt or shame' construct. According to Earley (1997), persons in a guilt-based culture take personal responsibility for inappropriate responses to societal issues, while in a shame-based culture individuals simply experience shame for what they see as externally imposed negative consequences emanating from issues they believe to be outside of their control We regard this aspect as pertinent to issues of sustainability due to the significant occurrence in the rhetoric of generation X and Y members appearing to indicate a growing inference that they 'blame' previous generations for not sufficiently addressing global sustainability issues (notwithstanding their willingness to embrace the positive effects brought about by industrialisation, immunisation and other more positive influences. As the new generation must ultimately take up the challenges of solving pollution, global warming and over-population, they will need to adopt the approach of 'us against the problem', rather than us against them' To achieve that change, an open agenda and transparent mechanisms such as the proposed framework will undoubtedly become essential.

Orientation

Hofstede's (1980) conceptualisation of masculinity versus femininity is often mistakenly associated with gender inequality when in fact it refers to the cultural orientation such as competitiveness and efficiency (the so-called masculine traits), as opposed to the co-operation and co-development (so-called feminine traits). It is clear that global sustainability demands a combined, coordinated and cooperative effort that is distinctly 'feminine' in orientation. In order to be successful, it also needs to be integrated into business environments that still remain predominantly 'masculine' in orientation.

Relationship to nature

The relationships that people have toward nature is an interesting and pertinent cultural dimension, construed by Kluckohn and Strodbeck (1961) as a tri-partite construct. Some people attempt to execute mastery over nature, harnessing it through technology, expertise and effort (typically the so-called Western cultures); others seek to find balance with nature so as to peacefully co-exist (typically the Pacific-rim cultural groups); a third are subjugated to it, destined to be controlled by nature, thus believing that any effort to change it is futile (typically a Middle-Eastern philosophy), according to Lane and DiStephano (1992). Where sustainability matters are concerned, businesses must accept responsibility for the impact of their actions on nature. To have global relevance, and so as not to alienate any sub-group, businesses need to adopt a sustainability performance monitoring and evaluation mechanism that can synergise all three sides of the tripartite model of man's relationship to nature.

3. External context

No business can ignore the opportunities and threats emanating from the external environment. Indeed, achieving organisational effectiveness depends on how well the business adapts to its external environment (Yukl, 2008). While this article addresses each of the six commonly associated external factors under the acronym, PESTEL, it also adds a seventh, which is considered highly relevant to the subject of sustainability, namely Ethics:

Political – all issues of global significance tend to become politicised (ref) and we already see that sustainability falls into that category, as some governments push for environmental responsibility and seek to implement policies directed thereto, while others choose to ignore the issue.

Economic – in businesses where historically the ultimate measure of success has been the 'bottom line' (ref), external factors are assessed as opportunities or threats according to their propensity to impact profits, either positively or negatively. In order for sustainability to become a fixture on the board meeting agenda, it needs have a relatable and measurable economic impact at the level of the firm.

Social – Societal influences, biases and idiosyncratic cultural constructs appear to be mutating at accelerated rates due to mass communication, world-wide travel, and indeed globalisation in general. Companies are seldom mono-cultural and ethno-centricity appears doomed to history, as staffing becomes increasingly polymorphous, resulting in a level of cultural complexity never before imaginable.

Technological – again changing at an alarming rate, every new technology brings with it sustainability challenges. History has already proven that yesterday's solutions give rise to tomorrow's problems, so it seems we are locked into a continuous cycle of problem – solution – problem, where technology is concerned. In modern times there is no doubt a greater reliance on technology, and with that a greater propensity to upset the delicate balance of ecology, perhaps unknowingly until future generations have to deal with its long-term negative effects. We would offer the field of gene morphology as an example.

Environmental – Let us consider just one environmental issue that is current and pertinent, namely climate change. So far only the global bankers and G20 politicians have seen an opportunity therein, namely a carbon tax. For the rest, global warming remains a horrendous prospect, threatening to change our habitat irreversibly with seemingly dire consequences.

Legal – There are daily reports of pending legislation surrounding sustainability issues, many of which will impact the competitive strategies of businesses falling under their jurisdiction.

Ethical – This factor has been added on account of its pertinence to sustainability, as we believe every firm needs to examine its 'conscience' and take necessary steps to ensure that it acts in accordance with the ethical principles it purports to uphold. By way of example, we offer the following two scenarios: The first is a company that has made fortunes by manufacturing and selling asbestos-based products, but now realises their products could contribute to life-shortening non-communicable disease in humans. The second is a company that has billions of dollars invested in mining sites around the world, but must confront the criticism that their continued removal of organic metals from the earth's crust may well prove at some future date to have adversely affected its gravitational, magnetic and/or orbital field, with disastrous and catastrophic consequences for human existence.

It is generally accepted that SMBs are impacted by relevant external factors. The potential effects prompt them to proactively consider strategies that exploit opportunities and neutralise threats. Industries and firms also need to be aware that, in a sustainability sense, there now exists an unavoidable symbiosis between the external and internal environments, i.e. certain strategies that they may decide to pursue will have an effect on external factors. The realisation that your firm is not only affected by the problem, but also contributing to that problem (like the motorist whose vehicle forms

part of a traffic jam), may afford sustainability issues a higher priority when strategic options are evaluated. Since all firms exert some degree of influence upon the collective external environment, however minute that influence may appear, there is at the very least the motivation of self-interest for taking an 'inside-out' look at the seven factors described above.

Some suggested measures that could underscore strategic objectives set by the firm in this arena are the following: Participation at policy-making levels, ethical pricing processes in imperfect markets, responsible adoption of technology.

4. Industry context

Sustainability issues undoubtedly impact some industries more than others. Whilst it is obvious that retail and service-related industries thrive on population growth, it may be less obvious that the agricultural sectors of the modern-day global economy are simply unable to keep up with demand. And while most countries are already on a developmental trajectory that will most certainly render their economies largely dependent on increased tertiary sector activity, there will always be a need to supply those economies with goods sourced from the primary and secondary economic sectors.

Michael Porter (1986) advises firms to consider the likely impact of industry forces. It will be incumbent upon industry leaders to assess industry life-cycle, competitive rivalry, supply-side economies, demand-side considerations including global distribution and logistics, as well as innovative new and substitute products, from the modern-day perspective of sustainability.

We offer it as an inevitable consequence of globalisation that industry lifecycles will shorten and competitive rivalry will become fiercer than before, as firms endeavour to capture market share during the (diminished-duration) high-growth phase of each industry's respective lifecycle. Substitute products and technologies will continue to increase at an accelerated rate, due to the ever-increasing propensity for technological innovation.

In view of the above-mentioned industry factors, the following examples of strategic objectives are offered for consideration and possible inclusion in the firm's sustainability framework: technology-maker or taker (degrees of improvement), innovator or imitator (investment in research and development), supply chain and distribution channel conflict management processes (index of cooperation/complaints).

5. Organizational context

Barney's (2001) Resource-Based View of the firm has been widely regarded as a way to analyse a firm's internal effectiveness. As well as providing a concise acronym (PROFIT), it reminds us to also distinguish between the short-term competitive advantages that can be derived from the firm's physical, financial and technical strengths, in contrast to the more sustainable competitive advantages associated with the firm's reputation, organisational capability and intellectual property. We discuss each of these now, beginning with the short-term internal factors and then moving on to the long-term:

Physical presence and Product – the firm is known to its market by its physical presence or location, and by its product range. Today there is increased pressure to select locations that do not adversely affect indigenous bio-diversity and there is added pressure on products to be environmentally-friendly, as in recycle-able, bio-degradable, organically-produced or treated, not tested on animals etc.

Financial – As every firm has budgetary constraints on investments and expenditures, added capital requirements to address issues of sustainability will be subject to careful planning and approval

requirements to address issues of sustainability will be subject to careful planning and approval procedures and will incur a necessary and unavoidable lag time before they can be implemented. The firms that become first-movers in sustainability issues may enjoy some competitive advantage from their efforts before others in their industry catch up.

Technical – the firm's resources, machinery, engineering and information systems are the tangible assets that render it capable of producing economies of scale and scope through efficiency and responsiveness hat enhance its competitive advantage in its chosen markets. Technical traditions and habits that negatively impact the firm's sustainability, however, need to be reformed.

Reputation – a company's reputation is derived from its historical legacy and its current positioning in the marketplace. Branding plays a prominent role in building a firm's reputation. Nothing can tarnish a brand more than it being associated with a scandalous event or incident. In current times, the apparent disregard for, or violation of, any principle of global sustainability can do irreparable harm to the brand. Examples of this include the accusations against Nike's alleged use of cheap labour in Thailand, and the practice of developed nations dumping their unwanted waste in less developed countries.

Organization – this aspect encompasses all of the intangible assets that create a firm's organisational capability, specifically the firm's governance structure and company culture. Organisation culture may essentially be described by the following ten processes (Robinson, 2008): the type of people employed, the way people are selected, how their further development is facilitated, what they are expected to do to earn promotion within the firm, how people's performance is measured/evaluated, how their efforts are rewarded and recognised, what type of organisation structure is prevalent, what style of management is preferred, how decisions are made, and how the firm defines its future. The exact way in which each of the ten processes is played out is unique to every firm. Essentially though, they ought to be 'in sync', i.e. balanced and congruent with the firm's development or life-cycle trajectory and its current progress toward its ultimate vision (Robinson, 2010). Integral to these is the social discourse within the firm, giving due regard to organizational politics (Mayes & Allen, 1977) in particular what characterises in group, as opposed to out-group, loyalties and memberships (Erez and Earley, 1993).

Senge (1991) established the concept of the learning organisation. This concept implies the setting of a work environment where people are encouraged to constantly develop their capabilities and produce the results they truly desire, while working towards a common goal. Learning is seen as an ongoing process that builds upon both success and failure. As in a military context, after-action-reviews are regarded as an effective way for business leaders to periodically evaluate progress toward business goals as well as their effectiveness. (Gino and Pisano, 2011:73). Similarly, Hollman and Tanzik (1977) suggested that objectives have to be periodically re-assessed.

Intellectual Property and Innovation Propensity – herein lies the hidden store of ammunition with which the firm takes confidence in its ability to withstand challengers to its market success. It is logical though that innovation must be purposeful and strategically sustainable as intellectual property, in order to produce profitable returns.

The following sustainability objectives are offered as examples of how internal factors can be incorporated into the proposed framework: Synchronicity of firm's internal processes (can be measured in terms of a congruency index), internal promotions (e.g. percentage of external appointments), brand equity, financial ratios, intellectual property registrations.

6. Leadership Context

> *Collective learning focused on improving long-term performance is more likely to occur when key stakeholders agree that it is important and will help them to achieve their individual objectives.(Yukl, 2009:52)*

Four types of leadership are discussed, namely transformational, authentic, ethical, charismatic. Once a strategic direction is formulated its implementation requires change leadership. We draw attention in this article to four types of change leadership in particular, namely authentic leadership, ethical leadership, transformational leadership, and charismatic leadership. Leaders also increase organizational performance by exerting influence upon performance determinants. Examples of such influences include:

- Displaying certain patterns of leadership behaviour in interactions with subordinates, peers, and outsiders
- Decisions on management programs, systems and organizational structure, that indicate bias or favouritism
- Determining the competitive strategy for the organization

As effective strategic leadership demands consistency and perceived fairness in the implementation of decisions (Yukl, 2008), the Sustainability Framework offers an opportunity for openness and transparency in strategic leadership decision.

Authentic Leadership

Authentic leaders act in ways that are true to their core beliefs and values, due to self-awareness and self-regulation. They therefore exert positive influences on followers, who aspire to similar values, a process that has become known as relational transparency. Relational transparency results in a trust relationship between leader and follower (Avolio, Walumbwa and Weber, 2009).

Self-awareness is a substantial factor for being authentic. This means not only knowing one's strengths but also being aware of one's weaknesses (George, 2003). A Sustainability Framework needs to incorporate values and beliefs of the authentic leader and use these as a benchmark for performance.

Ethical Leadership

Ethical leaders lead by example according to what is moral and in line with an organization's ethical context. Ethical leadership may be based on consequentialism, deontology or virtues. Its aim is to increase awareness of followers' own behaviour, while holding them accountable for their own decisions, actions and behaviour (Brown and Trevino, 2006).

Ethical leaders will not only lead in line with a code of ethics, but by example according to their own ethical values and beliefs. According to Brown and Trevino (2006) there are three situational factors that affect the ethical leader, namely: ethical role modelling, the extent to which he/she develops their organization's ethical context, and the moral intensity of the business issues faced.

With a reward system that is seen to be linked to right action, followers are more likely to act in accordance with what is right. Furthermore, when followers are treated with fairness and consideration a social exchange relationship develops between leader and follower based on trust, which in turn further enhances the willingness of followers to support an ethical leader (Walumbwa and Schaubroeck, 2009).

The positive business outcome of ethical leadership is therefore that it increases productive follower behaviour. A sustainability monitoring framework should assist in improving the performances of individual and business units if the goals and measures are truly in line with organizational values.

Transformational Leadership

Transformational leaders influence organizational culture by realigning it with the new vision. Their aim is to improve followers' level of performance to meet changed expectations (Bass and Avolio, 1993). According to Bass and Steidelmeier (1999: 181) 'transformational leadership must be grounded in moral foundations' and is made up of four components, namely, 'idealized influence, inspirational motivation, intellectual stimulation, and individualized consideration'.

Through idealized influence the leader can aim for high performance standards, which can be monitored by the sustainability framework. Inspirational motivation engages followers in new standardised goals, which would become embedded within the sustainability framework. Intellectual stimulation occurs as leaders allow followers to participate in the target-setting process, thereby ensuring that all employees understand why those specific performances have been chosen to be measured with the sustainability framework and how they all collectively link with the vision and implemented actions. With individualized consideration leaders evaluate organizational performance on at an individual level, not just at an overall company level, thereby ensuring that the unique potential of each member of the organization is harnessed.

Transformational leaders are able to get their followers to perform beyond the level of expectation by building relationships based on mutual trust and respect, which in turn enhances followers' work attitudes and satisfaction levels (Podsakoff, MacKenzie, Moorman, and Fetter, 1990). In summary, the proposed Sustainability Performance Monitoring Framework should be useful in transformational leadership as it aids the monitoring and evaluation of both individual and group performance based on a standardised set of parameters.

Charismatic Leadership

Charismatic leaders help their followers internalize beliefs by communicating an aspirational vision of the firm's future and ideology. Followers of the charismatic leader will show loyalty and will be more willing to implement their leaders' decisions without questioning their self-interest. (House, 2006; Howell and Shamir, 2005). What is not intended though is blind obedience to the leader.

The socialized charismatic leader is concerned about the common wellbeing of his followers, addressing their needs and motivating them to work towards a common goal. A Sustainability Framework will empower them to do so, without expecting blind submissiveness towards a set goal by making goals specific and measurable. Today's turbulent and unstable environment requires leaders to be flexible. It is therefore important that they understand the complexities associated with performance management (Yukl, 2008). Perhaps it is most significant that as far back as 1947, Weber (in Early, 1997:113) stated that "the role of charismatic authority is to create and institutionalize new orders of rules, traditions and procedures that eventually supplant the charismatic leader".

7. Individual-Personal Context

Individuals are social actors who respond to both external and internal stimuli, thereby actively engaging in the environment, enacting aspects of their social milieu, and engaging in sense-making actions in order to interpret observed patterns (Early, 1997).

Self-concept regulation

All people have a self-concept regardless of cultural or societal background. The self-concept defines an individual and profoundly influences their responses to internal and external stimuli (Wyer and Srull, in Early, 1997). The self-concept enables individuals to find and define their positions within given organisational and social systems. Self-concept is such a strong influencer that, at any given time an individual's personality is affected by it (Kihlstrom et al., 1988). This resultant working self, i.e. the part of the self that is active at any particular time, interacts directly with the social environment (Early, 1997). Furthermore, several psychological processes actively control self-concept (Erez & Early, 1993). These processes involve setting goals, developing and selecting strategies to accomplish the goals, evaluation of priorities, and self-monitoring of goal achievement (Locke &Latham, 1990). The self-concept forms a link between individual behaviour, the social context, and the cultural setting.

Self Identity

Self-identity determines how individuals define themselves among others. According to Breckler and Greenwald (in Sorrentino and Higgins, 1986) there are three sources, which have influence on self-identity, namely public, private and collective.

The public aspect of self regulates how well an individual is capable of adopting social rules and demonstrating that one is socially acceptable. The private aspect of self determines behavioural standards, goal setting and responsibility for personal outcomes based on internalized values and standards. Finally the collective aspect of the self focuses on how an individual can contribute to the common good (Hinkle & Brown, 1990; Stryker, 1980). It has already been noted that social identity theory implies that the self-image of an individual is affected by intergroup comparisons. This proposition was supported by the findings of Oakes and Turner (1980) regarding the negative effects to self-image resulting from 'out-group discrimination'. Turner's (1985) Self Categorization Theory (SCT) underlines the concept of intergroup behaviour and social identity. According to Turner (1985, in Early, 1997:106), SCT proposes, *inter alia*, that: 'self-concept is the fundamental component of a cognitive system, cognitive representations of self may take the form of self-categorizations, (and that) self-categorizations exist as part of a hierarchical system'. Furthermore, it has been noted that group formation appears spontaneously from a given context and that 'individuals are motivated to maintain a positive self-evaluation ... through a comparison of self and other member characteristics ... of the next higher level' (Turner et al., 1987, in Early, 1997:106). We assume that these principles apply to modern-day work places, therefore in order to make sustainability one of the constructs of self-categorisation, it would have to be perceived as a focus of those at the higher levels of an organisation.

Goal Attainment

Human behaviour is intended to be purposeful, therefore defined goals potentially enhance the social actors' performance (Locke and Latham 1990).

To achieve business goals, performance must be monitored and evaluated. To set certain benchmarks for task performance a goal should be timely distinguished into short-term and long-term goals. Additionally to keep the social actor motivated in the goal attaining process, goals should neither be too easy nor appearing to be impossible to achieve.

While top management carries the primary responsibility for determining what programs are relevant, coordinated efforts by leaders at all levels in the organization are necessary to ensure that programs are effectively implemented (Yukl, 2008, 712). The Sustainability Framework is a measurement tool, which can assist managers to focus individuals and business units.

Role Expectations

In an organization every individual has a role. Certain expectations come with that role.

Role conflicts arise when a social actor is required to solve multiple demands simultaneously. For example, a manager who is charged with the responsibility for two competing projects, though both may bring overall benefits to the organization.

Role difficulties can also arise from ambiguous tasks, i.e. where the required outcome is ill-defined, which then lead to demotivation and loss of strategic direction (Early, 1997). An example of ambiguous tasks would be a car manufacturer who invests in high performance race car production, while, at the same time, investing in alternative energies. The implementation of the proposed Sustainability Monitoring and Evaluation Framework will aid focus and negate ambiguity as it, not only ensures that the five strategic sustainability objectives are clearly stated and their respective metrics are transparent, but also, by the mathematics of its evaluation process, it offsets the progress made toward strategic objectives by retrogression in others. And their respective weightings.

Conclusion

This paper has proposed a Sustainability Monitoring and Evaluation Framework and stressed the importance of flexibility and adaptability according to the changing needs and priorities of organisations. It has been shown that the proposed model meets what are considered by the authors as the essential criteria of an effective mechanism. Specifically, it allows business leaders to involve staff in the decisions regarding key strategic sustainability objectives and the monitoring of progress toward their achievement. As a participative process it can also serve to motivate and empower individuals and groups within the firm, thereby strengthening ethical, authentic, charismatic and transformational leadership processes. It allows sufficient scope for the nurturing of self-concept, self-identity, role expectations, and goal achievement among individuals and organisational groups. It appears sufficiently robust to incorporate relevant concerns emanating from the firm’s external, industry, and organisational contexts, by virtue of a periodic, suggested annual, adjustment in performance targets and their respective weightings.

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Basel III's Corporate Governance Impact: How Increased Banking Regulations Pose Challenges to Corporate Compliance While Simultaneously Furthering Stakeholder Objectives

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Abstract

Basel III was primarily intended to provide additional regulations to prevent the collapse of financial institutions during times of liquidity crises. However, two primary reforms, namely the new capital adequacy framework and disclosure requirements, will not only prevent banks from failure during periods of financial distress, but also help promote corporate governance objectives. In the traditional model of corporate governance, shareholders will benefit from the stability of firms in which they have invested, as well as having access to accurate and complete financial statements. Additionally, non-shareholder stakeholders will benefit from increased systemic stability and avoiding the resulting problems that the 2007 financial collapse created, such as decreased access to consumer credit, stagnant wages, and skyrocketing unemployment. This article will attempt to outline the specific corporate governance benefits that Basel III will bring, focusing on how disclosure requirements and capital adequacy will help shareholders and stakeholders alike.

Keywords

Corporate Governance, Stakeholders, Basel III.

Introduction

The new Basel III banking regulations promulgated by the Basel Committee on Banking Supervision, while primarily intended to be a comprehensive set of international financial regulations intending to address bank capital adequacy, have the potential to have significant effects on corporate governance. Undercapitalization in banks played a key role in the 2007 financial crisis, deepening it and allowing it to spread and touch almost every industry in almost every nation's economy. New capital standards approved by the Basel Committee and adopted by a number of states, including the United

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States[1], have the potential to play a key role in corporate governance efforts by reducing risky, pro-management decision making patterns and increasing stability throughout the financial system. These benefits will positively impact not just shareholders, by promoting long-term and stable firm growth and management, but also have a beneficial on the livelihoods of non-shareholder stakeholders. Increasing the level and more importantly, the quality, of capital that banks and other financial institutions are required to hold will strengthen shareholder and stakeholder corporate governance efforts, at minimal cost to the firms involved.

Part II of this article will briefly discuss key reforms that Basel III has imposed, namely the rise in the level of capital, financial institutions must hold, as well as the strict requirements in the quality of the capital that can be counted for purposes of complying with the regulation. This discussion is by no means meant to be exhaustive or complete and is a basic look that is intended to give the reader a functional knowledge of the changes in order to better understand how this new set of banking standards will benefit corporate governance efforts. Part III of the article is intended to explicitly identify the connection between the imposition of new banking regulations and the benefits they impart in the realm of corporate governance by examining the practical effects on both shareholder and non-shareholder stakeholder objectives and platforms.

KEY REFORMS PROPOSED BY BASEL III

A. Measurement of Quantity and Quality of Capital

Basel III makes two primary changes to the existing banking regulation framework by (1) requiring an increase in the amount of common equity a bank must contain in relation to its risk-weighted assets (RWAs) and (2) mandating an increase in Tier 1 capital ratios.[2] Although, Basel III's capital ratios are based on Basel II's framework, they are significantly more onerous and, in fact, almost triple the size of bank's required capital reserve.[3] While the increase from the current 4% required minimum to 8% in total capital held[4] may seem like a drastic increase in capital reserve requirements, current banks have an average holding 8.79 per cent, well above the 7 per cent equity requirement of Basel III.[5] Basel's risk-based capital ratio requires not just an aggregate increase in gross capital held, but increases the quality standards for capital that qualifies towards Tier 1 and Tier

[1] Tom Braithwaite, *Banks Await Orders as Fed Acts on Basel III*, FINANCIAL TIMES (July 2, 2013), http://www.ft.com/intl/cms/s/0/94abb696-e337-11e2-9bb2-00144feabdc0.html#axzz2iboSFxb8 (noting that the Federal Reserve Board adopted the Basel III accord on July 2, 2013).

[2] Johsua N. Rudin, Note, Basel III: The Banking Band-Aid?, 6 BROOK. J. CORP. FIN. & COM. L. 621, 628 (2012).

[3] Candemir Baltali and Joseph Tanega, *Basel III: Dehybridization of Capital*, 8 N.Y.U. J. L. & BUS. 1, 11 (2011).

[4] The 8% of total capital held requirement is further broken down as Common Equity Tier One capital (CET1) is required to be at least 4.5% of the risk weighted assets held by the bank, aggregate Tier 1 capital must be at least 6%, and all capital held must ultimately equal 8% of liabilities. Andrew L. McElroy, An Examination of Basel III and the New U.S. Banking Regulations, 14 WAKE FOREST J. OF BUS. & INTELLECTUAL PROPERTY L. 1, 6 (2013).

[5] *Id. See also* Patrick Jenkins, *Q&A: What Is Bank Capital?,* FINANCIAL TIMES*,* Sept. 13, 2010, www.ft.com/cms/s/.../f98164ba-bf65-11df-965a-00144feab49a.html ("The average bank today probably has a core tier one ratio of about 7 or 8 per cent, compared with a regulatory minimum of 2 per cent, and a tier one ratio of 9 or 10 per cent, compared with a 4 per cent minimum.").

2 requirements.[6] One of the most important implications of the newest round of banking regulations is that it limits tier 1 capital to include common shares, retained earnings, and other reserves, while Tier 2 capital, and eliminating Basel II's tier 3 capital categorization.[7] Rethinking not just how much capital should be held by financial institutions, but also what kind of capital needs to be retained is essential to increasing financial stability and one of the "fundamental assumptions of Basel III is that the common equity component of tier 1 capital provides the greatest 'loss absorption' capacity"[8]. As a result, common equity must make up at least 50% of the bank's total capital and at least 75% of the bank's Tier 1 capital.[9]

B. New Regulations Bolster Liquidity

BASEL III's IMPACT ON CORPORATE GOVERNANCE EFFORTS

A. What is Corporate Governance?

Corporate governance is broadly categorized as "the process by which business decisions are made and the process by which persons who will make those decisions are chosen"[10]. However, it can be more narrowly seen as the framework to address the agency costs that corporations incur as a result of the diverging interests of shareholders and officers/directors.[11] There are a variety of different mechanisms that corporations, shareholders, and the legal system employ that constitute the corporate governance system, which is the legal and factual atmosphere in which publically held corporations operate.[12] While the traditional view is that corporate governance systems and structures are supposed to reduce agency costs by giving shareholders some iota of control over corporate

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[6] Increases in just the amount of capital held will not accomplish much to reform or stabilize the financial system. *See* Martin Wolf, *Basel: The Mouse That Did Not Roar,* FINANCIAL TIMES (Sept. 14, 2010), http://www.ft.com/cms/s/0/966b5e88-c034-11df-b77d-00144feab49a.html (noting that too much weight should not be placed in numeric increases in capital requirements, as increase in the amount of non-quality capital does not do much to strengthen financial stability). As a result, Basel III has also increased the requirements for the quality of capital that can be counted towards a financial institution's capital reserve requirement.

[7] Baltali and Tanega, supra note 1, at 18.

[8] *Id.* at 18-19.

[9] Sarah Padgett, Note, The Negative Impact of Basel III on Small Business Financing, 8 OHIO ST. ENTREPRENEURIAL BUS. L.J. 183, 185 (2013).

[10] David C. McBride, *For Whom Does this Bell Toll?*, 27 DEL. LAW. 28, 29-30 (2009).

[11] Cory Howard, *Amgen and Proving Materiality in Class Action Securities Litigation: How the Seventh and Ninth Circuit's Approach to Materiality Offers the United States Supreme Court the Chance to Reinforce Legal Mechanisms of Corporate Governance*, 13 WAKE FOREST J. BUS. & INTELL. PROP. LAW. 257, 268 (2013).

[12] Amir N. Licht, *The Mother of All Path Dependencies Toward a Cross-Cultural Theory of Corporate Governance Systems*, 26 DEL. J. CORP. L. 147, 149 n. 1 (2001)(noting that the 'corporate governance system' is made up of corporate governance rules (company law), corporate governance structures (shareholding patterns), and securities regulation rules).

decision makers[13], recently, academics and policymakers have begun to question whether stakeholders should be excluded from the corporate governance discussion.[14] As a result, when discussing Basel III's impact on corporate governance it is imperative that the effects on non-shareholder stakeholders are brought to the forefront, as the reforms that the newest round of banking regulations attempt to implement are to cure deficiencies that disproportionately hurt creditors, employees, and communities tied to corporations that participated in or were severely affected by the 2007 financial crisis.

B. Can Increased Compliance Costs Create a Market for Corporate Governance?

1. Basel III's Effect on Compliance Costs

One of the key concerns that banking industry professionals have expressed about the new banking regulations is that financial institutions will incur increased compliance costs from meeting new capital requirements to increased borrowing costs.[15] Although proponents of the new capital and banking regulations believe that the system-wide stability that the new regulations will create are worth any increased compliance costs at the firm level, policymakers have been warned that the costs could be significant.[16] However, not all financial institutions are concerned with the costs of implementing Basel III's capital regulations, as JPMorgan Chase has called the costs 'manageable' and noted that as recently as the second quarter of this year, their available capital levels already met the new proposed regulations.[17]

[13] Carol Goforth, *Proxy Reforms as a Means of Increasing Shareholder Participation in Corporate Governance: Too Little, but not Too Late*, 43 AM. U. L. REV. 379, 409 (1994)(noting that as shareholder participation in corporate governance forums has increased, reforms have been focused on increasing their power and say in the corporate affairs).

[14] For an extended discussion on the role of non-shareholder stakeholders *see generally*, John C. Coffee Jr., *Unstable Coalitions: Corporate Governance as a Multiplayer Game,* 78 GEO. L.J. 1495 (1990); Jonathan R. Macey, *Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective*, 84 CORNELL L. REV. 1266 (1999); Cory Howard, *Corporate Governance as an Economic Theory: Can Non-Economic Principles of Antitrust Law be Imported to Reduce Shareholder Primacy and Promote Stakeholder Objectives?*, 5 BOCCONI LEG. PAPERS __ (Winter 2014).

[15] *See* Michael Shari, *Missing Pieces*, GLOBAL FINANCE (Sept. 2011), http://www.gfmag.com/archives/141-september-2011/11358-preparing-for-basel-iii.html#axzz2iPMV3awE (quoting corporate executives who believe "the expectation is that this [Basel III] is going to increase overall costs for corporate and companies…to the extent that banks are being asked for a lot more capital, they only have two choices at the end of the day-either accept lower returns or find ways to increase their pricing". Although the Modigiliani-Miller Theorem and Professor Anat Admati of Stanford predict that increased costs in equity financing should conversely lower capital and debt based financing, a number of authors have challenged this assertion. *See generally* Cory Howard and Neil Jonas, *"Under Pressure": Basel III's Capital Adequacy Requirements Squeeze Broker-Dealer Returns on Equity, Increase Need for Imposition of Uniform Fiduciary Duties*, 7 JOHN MARSHALL L.J. __ (2013)(challenging the assertion that increased capital requirements will lead to reduced costs in other forms of financing and thus not have an effect on the value of the firm).

[16] Anghuman Gooptu, *Will Basel III Help or Hurt?*, CHICAGO POL'Y REV. (Apr. 24, 2012), http://chicagopolicyreview.org/2012/04/24/will-basel-iii-help-or-hurt/.

[17] Phillip van Doorn, *JPMorgan Calls Basel III Leverage Compliance 'Manageable'*, THE STREET (July 12, 2013), http://www.thestreet.com/story/11976639/1/jpmorgan-calls-basel-iii-leverage-compliance-manageable.html.

But what exactly are these 'costs' that seem to trouble financial institutions, policymakers, and regulators? Typically, there are two types of costs associated with the imposition of a new regulatory framework, direct costs, such as fees incurred for filing the requisite paperwork, and indirect costs, which can include management costs and the costs that firms internalize to meet new regulations, such as the cost of hiring new personal or training legal and compliance departments.[18] Recognizing the different costs associated with the implementation of new standards, whether they be pure corporate governance structures or financial regulations, is important because the level of firm and system compliance is tied to costs. If the compliance costs are significant firms can and have abandoned the market or opted not to comply with new regulations, especially if price to pay for noncompliance is not significant enough to scare financial markets into implementing Basel III's standards.[19]

2. The Market for Corporate Governance

Although a number of different parties, from institutional shareholders to individual stakeholders, would like to see corporations widely adopt a corporate governance framework, "the science of corporate governance shows that there is no market pressure for optimal corporate governance there is only market pressure for indulgent pro-management corporate governance law"[20]. However, new Basel III regulations, specifically a core metric that the Fed and other nation's central banks will measure and enforce, called the risk-based capital ratio, could align what are now seen as diverging market forces and create a demand for corporations, specifically financial institutions, to adopt corporate governance measures and abandon pro-management decision making. Prior to adopting Basel III's capital ratio, the U.S leverage ratio proved to be widely ineffective in stopping systemic threats to the financial system, as 297 banks failed in the early years of the most recent economic downturn.[21] In fact, a Government Accountability Office report found that leverage of the largest financial institutions consistently increased up until the 2007 collapse of the financial industry.[22] Therefore, even though Basel III's banking standards are not strictly a new corporate governance structure, it can, as a set of banking regulations, have an effect on firms that could force them to adopt pro-shareholder and pro-stakeholder policies, thus furthering the goals of corporate governance.

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[18] Anita Indira Anand, *An Analysis of Enabling vs. Mandatory Corporate Governance Structures Post-Sarbanes-Oxley*, 31 DEL. J. CORP. L. 229, 243 (2006)(dividing the costs of implementing new regulatory frameworks, specifically corporate governance frameworks, into direct costs and indirect costs).

[19] *Id.* at 244-245 (noting that high costs of complying with regulations can turn firms away from the market or lead them to forego implementing even mandatory regulation, especially if the cost of non-compliance is not significant enough to scare firms into adopting new regulatory structures).

[20] Steven A. Ramirez, *The Special Interest Race to CEO Primacy and the End of Corporate Governance Law*, 32 DEL. J. CORP. L. 345, 382 (2007).

[21] John Holman, *A Flawed Solution: The Difficulties of Mandating a Leverage Ratio in the United States*, 738

[22] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-739, FINANCIAL MARKET REULGATION: FINANCIAL CRISIS HIGHLIGHTS NEED TO IMPROVE OVERSIGHT OF LEVERAGE AT FINANCIAL INSTITUTIONS AND ACROSS SYSTEM 17, 19, 23-24 [hereinafter GAO LEVERAGE REPORT], http://www.gao.gov/new.items/d09739.pdf.

One of the motivating factors behind the new capital requirements of Basel III was the intent to discourage risky behavior and strengthen current regulatory oversight of financial institutions.[23] In addition to increasing both the kind and quantity of capital that a bank must hold, Basel III also attempts to reformulate the calculation of risk-weighted assets to discourage banks from using off-balance sheet vehicles to obfuscate the true size of the bank's exposure to risk.[24] It is the heavy use of these off-balance sheet vehicles that have proved problematic for regulators and have led to the collapse or financial distress of both financial, and non-financial, institutions. In the current market for corporate governance regimes there is simply little incentive for executives to minimize the type of risk taking through off-balance sheet leveraging, as it proves only problematic in times of liquidity and economic distress. To the contrary, current executive compensation practices actually encourage this type of short-term risk behavior by executives.[25]

So what does this mean for corporate governance? Basel III, although it may come with compliance costs, which may end up being significant, has the power to actually skew the market for corporate governance by making it more costly for managers to pursue short-term risk. Although scholars and policy-makers are concerned with the ability of financial institutions to skirt the new regulations[26], managers would incur the costs of violating federal regulations and international standards to pursue short-term risk. The additional discouragement to holding risky assets that Basel III implements not only promotes shareholders' desire to see managers act in the best long term interests of the company[27], but also achieves stakeholder objectives, principally by ensuring firm-wide and systemic stability.

4. Financial System Stability Could Prevent Another 2007 Collapse

Although Basel III will likely be able to act as a key mechanism in corporate governance by forcing managers away from pro-management decision making that benefits shareholders by ensuring firm stability, it also has the potential to radically help non-shareholder stakeholders. The most recent

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[23] Tom Braithwaite, *Banks Await Orders as Fed Acts on Basel III*, FINANCIAL TIMES (Jul. 2, 2013), http://www.ft.com/intl/cms/s/0/94abb696-e337-11e2-9bb2-00144feabdc0.html#axzz2iPRbNz2T.

[24] Wulf A. Kaal, *Hedge Fund Regulation Via Basel III*, 44 VAND. J. TRANSNAT'L L. 389, 444 (2011)(noting that "central to the rules is an attempt to prevent banks from using off-balance sheet vehicles and risk-weighing methods to hide the true size of their balance sheets").

[25] *Cf.* Simone M. Sepe, *Making Sense of Executive Compensation*, 36 DEL. J. CORP. L. 189, 196-197 (2011)(noting that the standard view among academics after the financial crisis is that equity-based executive compensation packages incentivize managers to take short-term risks); Christine Hurt, *Regulating Compensation*, 6 OHIO ST. ENTREPRENEURIAL BUS. L.J. 21, 54 (2010-2011)(noting that prior to TARP imposed restrictions on executive compensation, financial firm's compensation practices before the 2007 collapse encouraged intra-firm risk, which, when duplicated throughout interconnected firms, increased systemic risk. However, the author notes that even if risk was perpetrated at the firm level, there is no evidence that it contributed to the collapse of the U.S. economy).

[26] Bank's evasion of financial regulation has always been a problem for regulators, as bank risk models and political pressures may be too much for regulators to be able to carry out effective oversight. *See* Holman, *supra* note 16, at 747 (listing a number of factors, including complex risk modeling, greater bank resources to skirt regulations by developing new models that regulators do not understand, and political pressure, as factors that inhibit enforcement of federal regulation).

[27]

financial crisis, which was precipitated by the near-collapse of the financial system, devastated not just shareholders, but specifically and critically hurt corporate stakeholders. Employees, for example, have suffered from decreased employment stability, stagnant wages, and delayed retirement because instability in the financial markets had catastrophic effects that touched almost every industry.[28] While Basel III is concerned primarily with ensuring that banks and other financial institutions have the requisite capital to withstand another financial crisis,[29] it is exactly this predicament that deepened the most recent financial crisis.

C. Transparency and Increased Disclosure Requirements

1. General Disclosure Requirements Strengthen Transparency Efforts

One of the stated objectives of the Basel III standards is not just to increase capital quality and minimum amounts, but to improve transparency of the capital base as well.[30] For example, U.S. regulators have required financial holding companies to submit detailed reports that outline the institution's plan for complying with both the Dodd-Frank Act and Basel III.[31] Transparency is not just a useful byproduct of post-financial crisis standard setting; rather, there is a concerted efforts amongst financial regulators to address the perceived inadequacy of transparency mechanisms.[32] However, to date, academics, courts, and private organizations have been primarily concerned with efforts to increase non-firm specific transparency. The focus on financial regulation appears to be on whether the Basel Committee publishes their standards online, whether governments embrace transparency and open rulemaking processes, or whether administrative agencies open up their rulemaking for public comment.[33]

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[28] Binyamin Appelbaum, *Recession's Lasting Effects*, EXONOMIX: NEW YORK TIMES (Mar. 23, 2012), http://economix.blogs.nytimes.com/2012/03/23/recessions-lasting-effects/ (noting that chronic employment, stagnant wages, and future earning potential of workers have all been damaged by the 2007 recession).

[29] Emilios Avgouleas, *Rationales and Designs to Implement An Institutional Big Bang in the Governance of Global Finance*, 36 SEATTLE U. L. REV. 321, 373 (2013)(noting that the promulgation of Basel III was intended to address chronic undercapitalization of financial institutions).

[30] *See* BASEL COMMITTEE ON BANKING SUPERVISION, BANK FOR INTERNATIONAL SETTLEMENTS, STRENGTHENING THE RESILLANCE OF THE BANKING SECTOR: CONSULTATIVE DOCUMENT 13 (2009), http://www.bis.org/publ/bcbs164.pdf (noting that the highest priority issues for Basel III was the "need to strengthen the quality, consistency, and transparency of the regulatory capital base".).

[31] Andrew L. McElroy, *An Examination of Basel III and the New U.S. Banking Regulations*, 14 WAKE FOREST J. OF BUS. & INTELLECTUAL PROPERTY L. 1, 4 (2013)(*citing* BD. OF GOVERNORS OF THE FED. RESERVE SYS., COMPREHENSIVE CAPITAL ANALYSIS AND REVIEW: OBJECTIVES AND OVERVIEW 1 (2011), available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20110318a1.pdf.).

[32] Caroline Bradley, *Transparency is the New Opacity: Constructing Financial Regulation After the Crisis*, 1 AM. U. BUS. L. REV. 7,7 (2011).

[33] *Id.* at 12-14 (noting a number of transparency-related reforms that have been implemented in post-financial crisis rulemaking. Notably absent from the discussion of major success are firm-specific efforts to increase corporate transparency).

This type of general, non-firm specific efforts at transparency are essential to furthering corporate governance objectives at both the shareholder and stakeholder level as it encourages participation in disenfranchised segments of corporate constituencies.

2. Basel III's Firm-Specific Disclosure Requirements Achieve Corporate Governance Objectives by making Transparent Previously Hidden Information

Although increased transparency in the dissemination of regulations does further corporate governance objectives, what is particularly notable about Basel III are the firm-specific disclosure requirements. Just as the disclosure requirements of the Dodd-Frank Act were intended to promote accountability,[34] the disclosure requirement of Basel III are intended to all shareholders, or at least potential shareholders, to get an accurate picture of a financial institution's financial statements, insuring that banks maintain proscribed capital reserves and acceptable leverage ratios.[35] But it is not just the mandatory disclosure that makes Basel III a stronger corporate governance tool than Dodd-Frank, but the specific enunciation of what must be disclosed.

For example, paragraph 56 of the Disclosure Requirements force a bank to report a "breakdown of the following exposures under the scope of consolidation of the leverage ratio framework: on-balance sheet exposures, derivative exposures, securities financing transaction exposures, and other off-balance sheet exposures"[36]. The inclusion of off-balance sheet exposures is important because off-balance sheet exposures have posed systemic threats to the United States, and worldwide economy, since the collapse of Enron[37] and several other important corporate governance and financial regulation legislation have been unsuccessful in forcing their compete disclosure. Section 401(a) of the Sarbanes-Oxley Act ("SOX") attempted to mitigate the risk of hidden liabilities by forcing companies to disclose *material* off-balance sheet transactions.[38] By assigning a credit conversion factor to each particular type of off-balance sheet exposure[39] and specifically enunciating the types of off-balance sheet exposures that banks must disclose, regulators under Basel III are able

[34] *See* The Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank]; Mirela V. Hristova, *V. Dodd-Frank's Corporate Governance Reform*, 30 REV. BANKING & FIN. L. 516, 519-520 (2011).

[35] *See* BASEL COMMITTEE ON BANKING SUPERVISION, REVISED BASEL III LEVERAGE RATIO FRAMEWORK AND DISCLOSURE REQUIREMENTS 8 ¶44 [HEREINAFTER, "DISCLOSURE REQUIREMENTS} (June 2013), *available at* *http://www.bis.org/publ/bcbs251.pdf*.

[36] DISCLOSURE REQUIREMENTS, at ¶56.

[37] *See* Jim Brunsden, *Bank's Off-Balance-Sheet Risks Come Under Basel Scrutiny*, BLOOMBERG (Sept. 30, 2013), http://www.bloomberg.com/news/2013-09-29/banks-face-basel-debt-limit-capturing-off-balance-sheet-risks.html (noting that complex banking procedures, specifically the shifting of risky assets and liabilities off of a bank's disclosed balance sheet was one of the primary causes of the 2007 collapse).

[38] Sarbanes-Oxley Act of 202, Pub. L. No. 107-204, § 401, 116 Stat. 745, 786 (codified in scattered sections of 15 U.S.C.)(requiring the disclosure of "off-balance sheet transactions that may have a material current or future effect on the financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses").

[39]

to better quantify the true leverage of a bank,[40] and for what appears to be the first time, take proper inventory of a bank's off-balance sheet exposure.[41] In addition to the disclosure of off-balance sheet holdings, Basel III requires banks to publish "contractual mismatches between on- and off- balance sheet flows at various time frames…[and] explain how such mismatches will be bridged."[42]

These new disclosure requirements of Basel III do not appear to be the same smoke-and-mirror reforms that Sarbanes-Oxley imposed in the post-Enron era. While SOX § 401(a) and Rule 46-R both came under heavy scrutiny in the immediate aftermath of the 2007 credit crunch for their failure to appropriately control off-balance sheet exposure, specifically the proliferation of dangerous special-entity vehicles[43], Basel III has greater disclosure and regulatory power. One of the main criticisms hurled against SOX's § 401(a) was that it permitted liabilities to be left off quarterly and annual disclosures when the risk primarily laid with others, which left investors without knowledge of unreported risk until the risk went bad.[44] However, Basel III's itemized disclosure of derivatives and other risk-bearing liabilities, which is not dependent on a easily manipulated decision of where the risk may lay, coupled with contractual mismatch explanations, promises to ensure that investors and regulators are able to identify off-balance sheet risk before it becomes a problem. This does not just increase firm-specific transparency in a meaningful way, it also enfranchises both financial regulators and shareholders, two parties who have often met stiff resistance in their attempts to participate in the corporate governance efforts aimed at financial institutions.[45]

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[40] SHADOW FINANCIAL REGULATORY COMMITTEE, STATEMENT OF THE SHADOW FINANCIAL REGULATORY COMMITTEE ON IMPROVING CAPITAL ADEQUACY DISCLOSURE 2 (Feb. 11, 2013), http://fic.wharton.upenn.edu/fic/Policy%20page/Statement%20No.%20335%202.13.pdf (recommending adoption of the Basel Committee's proposed leverage ratio as it better accounts for off-balance sheet liabilities in measuring total exposure).

[41] Financial institutions and companies, such as Enron, had been able to manipulate loopholes in disclosure rules and securities regulation by not-reporting off-balance sheet exposures that totaled substantial sum of recourse debt; debt which was not factored by credit agencies which eventually led to the precipitious collapse of the firm. *See* Frank Partnoy, *A Revisionist View of Enron and the Sudden Death of "May"*, 48 VILL. L. REV. 1245, 1250-1251 (2003)(explaining how Enron manipulated non-disclosed off-balance sheet exposures to artificially buoy its credit rating and access to cheap forms of liquidity).

[42] Adrian Blundell-Wignall and Paul Atkinson, *Thinking Beyond Basel III: Necessary Solutions for Capital and Liquidity*, 2010 OCED JOURNAL: FIN. MARKET TRENDS 9, 28 (2010).

[43] *See* Floyd Norris, *Off-the-Balance-Sheet Mysteries*, N.Y. TIMES (Dec. 8, 2008), http://www.nytimes.com/2008/02/28/business/worldbusiness/28iht-norris29.1.10520588.html?_r=0 (raising questions as to the efficacy of SOX's off-balance sheet exposure reporting requirements).

[44] *Id.*

[45] *See* Oskari Juurikkala, *The Behavioral paradox: Why Investor Irrationality Calls for Lighter and Simpler Financial Regulation*, 18 FORDHAM J. CORP. & FIN. L. 33, 78 (2012)(noting that financial regulators often fail in their responsibilities because of lack of information, deficient skills, as well as incentive problems); Carrie Stradle Lavargna, *Government-Sponsored Enterprises are "Too Big to Fail": balancing Public and Private Enterprises*, 44 HASTINGS L.J. 991, 1019 (1993)(noting that governmental interests are placed above shareholders rights and give them no power to control or seek redress against financial instability of financial institutions). This presents an interesting conundrum for financial regulation, as both regulators and shareholders have been deemed incapable of controlling financial institutions.

Greater transparency at the firm level, especially disclosure of accurate financial statements is one of the most significant corporate governance (and regulatory) advancements in the post-Great Recession environment and has long been an objective of the Obama Administration. In fact, a White Paper published by the Obama Administration, "A New Foundation: Rebuilding Financial Supervision and Regulation", was, if not the first, then the most radical, call to imbue regulators with the power to eliminate risky behavior in the financial sector before it could become a systemic threat.[46] One of the primary concerns that the report sought to remedy was the existence of inadequate disclosure regimes, which skewed risk-based decisions taken by lenders, securitizes, and investors.[47] Therefore, the white paper, proposed, among a number of other reforms, increased public disclosures by Tier 1 Financial Holding Companies (Tier 1 FHC) in order to allow investors, regulators, and market participants to properly evaluate the risk profile, risk management ability, and capital adequacy of systemically important financial companies. The increased disclosure standard of Basel III will accomplish this goal, albeit six years after the public release of the white paper, by forcing banks and financial institutions to make disclosures of capital holdings, off-balance-sheet assets (which have in the past proved to be a major source of hidden risk), and otherwise unregulated derivatives.

This benefits investors and market participants by permitting them to get an accurate view of a publically traded financial institution's risk exposure, but also reduces the risk to the financial system. Publically traded financial institutions such as Citigroup, Bank of America, J.P. Morgan Chase and others will be forced to make accurate disclosures, lest their incorrect disclosures be used as evidence in a Rule §10b-5[48] class-action securities lawsuit against the bank. Not only does Basel III's disclosure requirement benefit shareholders and potential market participants through the guarantee of correct, and absolute, disclosure, but it also protects consumers and corporate stakeholders by buttressing the stability of the financial system. This occurs not only through increased confidence in transparent financial institutions, but also by enhancing market discipline.[49]

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[46] Robert G. Kaiser, ACT OF CONGRESS: HOW AMERICA'S ESSENTIAL INSTITUTION WORKS, AND HOW IT DOESN'T 92 (2013)(noting that the white paper commissioned after the beginning of the financial collapse of 2007 introduced the idea of terminating risky financial behavior before it could threaten the system, considered a novel reform in American capitalism).

[47] DEP'T OF THE TREASURY, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 44 (2009).

[48] S.E.C. Rule 10b-5 is a regulatory prohibition against the type of activity prohibited by §10(b)of the Securities Exchange Act of 1934. *See* 15 U.S.C. §78j(b). In a typical §10(b) action the plaintiff must prove (1) material misrepresentation or omission by the defendant (an issuer of securities), (2) scienter, (3) a connection between the misrepresentation or omission and the purchase or sale of security, (4) reliance, (5) economic loss, and (6) loss causation. *See* Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336, 341-342, 125 S.Ct. 1627 (2005).

[49] Press Release, Financial Stability Board, FSB Welcomes Implementation Progress Report by the Enhanced Disclosure Task Force (Aug. 21, 2013), *available at* *http://www.financialstabilityboard.org/press/pr_130821.pdf*.

CONCLUSION

Although the new standards promulgated by the Basel Committee on Banking Supervision are primarily seen as a way to achieve financial system-wide stability, they also have the ability to significantly further corporate governance objectives, especially those of non-shareholder stakeholders. These corporate governance objectives will be advanced in two primary methods: (1) increasing the capital adequacy requirements of financial institutions and (2) by increasing transparency. Both of these components of financial regulation are currently undergoing strenuous reform, as financial holding companies will be forced to recalculate their capital retention levels and enhance their public disclosures, including a number of previously hidden, but risky liabilities, to investors and stakeholders. By forcing banks to not only hold more capital, and improve the capital of the quality held, as well as force banks to disclose, and thus discourage the holding of liabilities that greatly enhance risk exposure, Basel III will use firm-specific reforms to enhance the stability of the financial system as a whole. Therefore, giving shareholders a clearer image of the risk management capabilities of potential investors is not the only corporate governance reform that Basel III brings, but it also reduces agency costs by discouraging management's high-profit, high-risk, short-term profit maximizing decision making, but also protects consumers, borrowers, and other unseen victims from another 2007 financial catastrophe.

Relationships of Corporate Governance Mechanisms and Financial Performance in Islamic Banks: A Meta-Analysis

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Abstract

Relationships between corporate governance mechanisms and the financial performance of Islamic banks have been researched extensively in prior empirical research. However, the results are mixed, mainly due to the heterogeneity of the samples used for the empirical investigations. This paper reports the results of a meta-analysis of the existing literature on governance mechanisms from which a framework was developed to guide the constructions of governance indices. The results showed that Islamic banks banks tend to have better financial performance if there was (1) a higher proportion of independent directors on the board; (2) the Shari"ah Supervisory Board was large and consisted of top scholars; (3)numerous directors; (4) the CEO was chairman; (5) auditing was enforced and (6) ownership structure was dispersed, reducing shareholding of directors, foreigners and institutional investors, while increasing family and governments' shareholding. Managers' shareholding was insignificant.

Keywords

corporate governance, financial performance, meta-analysis, Islamic banks

Introduction

On September 15, 2008, Lehman Brothers Holdings Inc., the 4th largest investment bank in US, filed for Chapter 11 bankruptcy protection, marking the largest ever bankruptcy in the American history. It was followed by the massive exodus of most of its clients, drastic losses in its stock, and devaluation of its assets by credit rating agencies. The aftermaths of the 2008 US subprime mortgage crisis urged the banking sector to review their governance models. Rarick (2009) introduced the "Islamic system" as an optimal substitute to the existing capitalistic model to the Global Financial Crisis. However, without proper understanding of the role corporate governance play on the performance of Islamic banks themselves, how dare one suggest such quick remedy?

Corporate governance has already grown into an established and well studied subject being in academia as well as in practice (Clarke, 2004, Classens, 2006). Corporate governance is mainly concerned with control and decision making at the top of organisations and, in particular, corporate boards' roles, composition and accountability. Until now, corporate governance has mostly been dedicated to and concerned with traditional western corporations. Many studies have focused

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on large western banks with many thousands of employees, and that are publicly traded on the stock market with a free float of shares of shareholders with only a small proportion of equity held in the firm. There is only scarce evidence on corporate governance in the Islamic banking sector.

The dramatic growth of the Islamic banking sector around the world merits its significance in the financial market. Hence, the focus of this study was to summarise the evidence for, and determine the relationship between, corporate governance and financial performance of Islamic banks. This would also identify areas for future research as well as inform policy decision-making by Islamic banking regulators.

Thus, the research question is: What is the relationship between corporate governance mechanisms and financial performance of Islamic banks?

For Islamic Financial institutions, conflicts of interest are two-folded, meaning that they have to face the separation of ownership and control as well as the Shari"ah compliance on behalf of the regulators. Thus, this paper analyses both traditional corporate governance mechanisms applicable to Western banks and the Shari"ah Supervisory Board (SSB).

The rest of the paper proceeds as follows: Section 2 reviews the literature pertinent to corporate governance and financial performance of Islamic banks and develops the research hypotheses, covering six major corporate governance mechanisms, namely board independence, Shari"ah Supervisory Board (SSB), board size, CEO duality, ownership structure and auditing. Section 3 provides the methodological details of the meta-analysis. The results are reported in Section 4. Section 5 concludes with a summary and discussion of the research findings, acknowledges the limitation of this study, and identifies future research directions.

LITERATURE REVIEW AND RESEARCH HYPOTHESES

A literature search has identified a number of governance mechanisms pertinent to the financial performance of Islamic Banks, including board independence, Shari"ah Supervisory Board (SSB), board size, CEO duality, ownership structure and auditing (Chapra and Ahmed 2002). Thirteen research hypotheses concerning each corporate governance mechanism were drawn from the relevant literature reviewed below.

2.1 Board independence

Under Agency Theory, independent directors are more likely to be effective in monitoring the control of assets by the professional managers in that the independent directors are more likely to objectively question and evaluate the performance of both management and the firm (Kesner and Johnson 1990). Prior research suggests that there is an association between independent directors and stronger corporate governance, in the forms of reducing the likelihood of a firm paying greenmail and facing shareholder lawsuits, experiencing a negative market reaction to the announcement of a poison bill adoption, more appropriate design of CEO compensation policy, acting on behalf of stakeholders in order to secure higher premiums for tenders, making better acquisition decisions and promoting ethical financial reporting codes (de Villiers, Naiker, et al. 2011).

H1: There is a positive relationship between board independence and financial performance.

2.2 Shari"ah Supervisory Board (SSB)

The main distinction between Islamic banks and conventional banks lies in the requirement for the operations of Islamic banks to be in accordance with the Islamic Shari‟ah. This requirement provides the foundation for the operation of Islamic banks to be guided by the principles and values laid down in Islam. Furthermore, it has been argued that the integrity of an Islamic bank would be undermined, and stakeholders would lose confidence, if its operation was found to be non-compliant to the Shari‟ah (Alman 2012).

As the main objective of the establishment of an Islamic bank is the provision of financial activities that are Shari‟ah compliant, the shareholders and stakeholders of an Islamic bank are expected to put pressure on the bank to accomplish this objective. The investment decision of the shareholders, for

example, is deemed to be influenced by the assurance that the activities of the bank and the profit generated from them are Shari‟ah compliant. In addition, institutional investors who usually hold a large stake in the shareholding of a corporation would exercise their voting power to decide on the policies and business operations that would provide a positive return on their investment while ensuring the ethical aspect of the Islamic banking operation remains intact. Meanwhile, to ensure that the credibility of the bank is preserved in accordance with the expectations of these shareholders, the board of directors would monitor the management and require the latter to report to them that the activities of the bank are Shari‟ah compliant. These tasks are undertaken with the assistance of an external and independent Shari‟ah board which comprises experts on Shari‟ah and on fiqh al-mua‟malat-related knowledge. The Shari‟ah board advises the board of directors on the Shari‟ah aspects of the Islamic banking operation and the latter carry out a Shari‟ah compliance review of the bank. The conclusions drawn by the Shari‟ah board based on the results of the Shari‟ah compliance review are published in a Shari‟ah report that is issued annually along with the financial statements of the bank.

The Shari‟ah compliance review of an Islamic bank's activities is considered to be a crucial governance mechanism to ensure the credibility and viability of the financial institutions because of the requirement for Islamic banks to adhere to the Islamic Shari‟ah principles. For this reason, many banks offering Islamic banking products and services have established a SSB whose membership and hierarchical position in the bank is deemed to stand no comparison to other types of supervisory boards.

The available literature presents a growing interest in the issue of the governance functions of the Shari‟ah board in Islamic banks (Hassan 2012). According to Hassan (2012), in the Islamic Banking industry, the SSB mainly serves the following three functions: (i) at the macro level, SSB assumes regulatory authority; (ii) SSB at the micro level supervises the Shari"ah compliance of the Islamic banks; (iii) SSB is an useful source for business development; and (iv) SSB operates independently.

H2: SSB is positively related to the financial performance of Islamic banks.

2.3 Board size

Of all the corporate governance mechanisms, boards of directors and in particular board composition and board size have received much attention in the media and business community (Adams, Hermalin et al. 2008; Brown, Beekes et al. 2011; van Essen, Oosterhout et al. 2012). However, a confirmative answer for the relationship between board size and performance of small firms is yet to be established. Agency Theory argues for a smaller board in that it saves transaction costs associated with the group thinking problem and related unnecessary costs to reach consensus. While the Resource Dependency Theory claims that a larger board will not only provide the monitoring function of the boards but also enrich the Islamic bank's resource in the form of their collection of expertise and resources.

H3: Board size is positively correlated with financial performance of Islamic banks.

2.4 CEO duality

A dual role of CEO and chairman is a key characteristic of insider power and considered an indicator of weak corporate governance (Larcker et al. 2007, Yermack 1996). Most U.S. companies have traditionally appointed a single individual to the roles of both chairman of the board and CEO. This concentration of power can permit the CEO to effectively control information available to other board members and can impede effective monitoring (see Jensen, 1993).This duality was present in companies involved in fraud (e.g., Enron, Worldcom, and Global Crossing). As well, Beasley et al. (1999) found that the CEO was involved in 72% of the frauds which they examined. Several studies have examined the separation of CEO and chairman of the board, positing that agency problems are higher when the same person occupies the two positions. Using a sample of 452USA public firms between 1984 and 1991,Yermack (1996) showed that firms are more valuable when the CEO and the chairman of the board positions are occupied by different persons. Carpeto et al.(2005) found that the decision to split the roles of CEO and board chair is associated with positive and significant abnormal returns. Similarly, Larcker et al. (2007) concluded that the duality role of CEO and chairman is a key

indicator of weak corporate governance. Therefore, the Cadbury Committee recommended separating the roles of the CEO and board chair to ensure a clear division of responsibilities at the head of the company (Al Manaseer, Al-Hindawi, et al. 2012).

H4: CEO duality can improve the financial performance of Islamic banks.

2.5 Ownership structure

According to Berle and Means (1932), the modern corporation is characterized by the separation of ownership from control. Recent work on separation of ownership and control has shown that ownership concentration levels have important implications for firm performance. The impact of ownership on firm performance is two-folded. On the one hand, the size of ownership stake and the incentive to monitor are positively correlated. Concentrated ownership can also provide better control of management (Jensen and Meckling 1976), which can benefit minority shareholders by improving the monitoring of managers (Shleifer and Vishn 1997). On the other hand, it can come with costs for minority shareholders as controlling owners might try to expropriate greater benefits from the firm (Grant and Kirchmaier 2004).

H5: Concentrated ownership leads to better financial performance in Islamic banks.

Ownership may exist in one of the following six forms, namely blockholding, director ownership, family ownership, foreign ownership, government ownership, institutional ownership, and management ownership (Abbas et al. 2009).

Blockholding, also called concentrated ownership, incurs the least agency cost given that the owner did not trade the control of assets with management (Jensen and Meckling 1976). Hence

H6: Blockholding adds value to the financial performance of Islamic banks.

Even though share ownership by directors may provide incentives for directors to exercise diligent monitoring, the massive shareholding by directors may conflict with the interests of the other shareholders.

H7: Director ownership has a negative impact on the financial performance of Islamic banks.

Family ownership is expected to be positively related to firm performance since it helps reduce the agency costs of separation of ownership and control. In this type of firms, the interest of the managers is naturally aligned with those of the owners since the owners are also the managers who could bring benefits to the firms (Abbas et al. 2009).

H8: Higher family ownership is associated with higher financial performance in Islamic banks.

Kho and Stulz (1997) find no evidence that the foreign investors outperform the local investor in Japan. Moreover De Young and Nolle (1996) and Elyasiani and Mehdian (1997) found that foreign-owned banks were not as profitable as domestically owned banks. De Young and Nolle (1996) reasoned out that foreign owned banks were less profitable because of their reliance on purchased funds. Elyasiani and Mehdian (1997) concluded that foreign-owned banks tend to be less cost-efficient than domestic banks, which in turn affects profitability.

H9: Foreign ownership has negative relationship with financial performance of Islamic banks.

Ab Razak et al. (2008) argued that the government ownership contribute positively to performance, mostly due to the investments made by government through their various government related companies. It is believe that a government will take action to avoid underperforms of their investment in companies in which they invest. Based on these arguments the study hypothesizes that:

H10: Higher the government ownership has positive effect on financial performance of Islamic banks.

The emergence of institutional investors (owners) as active owners has resulted in studies investigating their role as active monitoring agents for enhancing firm performance. It is argued that only large shareholders such as the institutional investors can achieve sufficient benefits to have the incentive to monitor managers and members of the board (Shleifer and Vishny 1986). However, the

assignment of representatives – agents of the institutions would incur extra agency cost and hence making the institutions 'inactive'.

H11: Institutional investors have a positive impact on financial performance of Islamic banks.

Management ownership may align the interest of the managers and shareholders and hence improve the financial performance (van Essen and Osterhout 2008).

H12: Management ownership is positively associated with financial performance of Islamic banks.

2.6 Auditing

Auditing facilitates the Shari"ah compliance and encourages the Islamic banks to adopt appropriate financial reporting codes and good practice (Brown et al. 2011).

H13: Auditing is positively correlated with financial performance of Islamic banks.

Table 1 Definition of the variables

Variable	Definition
Board size	Number of board of directors
Financial performance	ROA, ROI, Tobin's Q
Board independence	Percentage of independent directors on the board
Shari"ah Supervisory Board	The SSB size, percentage of SSB members on top 20 ranking
CEO duality	Whether the CEO is also chairman.
Ownership structure	The percentage of shares held by the largest five shareholders.
Auditing	Whether the firm has been externally audited.
Director ownership	The proportion of shares held by the directors.
Family ownership	Whether the largest shareholder is family.
Foreign ownership	Whether foreigner own shares.
Government ownership	Whether the largest shareholder is the government.
Institutional ownership	Whether the largest shareholder is the institution.
Blockholding	Whether the shares are held by the largest three shareholders.

METHODOLOGY, DATA AND RESULTS

The methodology included a meta-analysis of existing research to identify previous research and testing of hypotheses based on the evidence derived from these previous studies.

Meta-analysis

To address the theoretical debates and to consolidate existing knowledge, this study systematically reviewed all the empirical evidence obtainable from a number of database sources specified below. Literature which met the criteria was quantified to test the statistical hypothesis using a meta-analysis approach.

Sampling and coding

Five complementary strategies were used to identify the population of studies on corporate governance and financial performance of Islamic Banks, (Li. et al. 2013). First, six databases were searched using key terms, "board", "board of directors", "board size", "board independence", "Shari"ah Supervisory Board (SSB)", "CEO duality", "ownership structure", "blockholding", "director ownership", "family ownership", "foreign ownership", "government ownership", "institutional ownership", "management ownership", "auditing", "board characteristics", "governance", and "corporate governance", married with "Islamic Banks", "Islamic Financial Institutions". The databases include (1) JSTOR; (2) ProQuest ; (3) ABI/INFORM Global; (4) EconLit; (5) SSRN; (6) Google Scholar.

Second, a search was conducted of the most relevant journals suggested by the Australian Research Council's ERA Ranking in the fields of accounting, economics, finance and management. Third, after collecting an initial set of studies, a "snow-balling" technique cross-checked the reference that cited the original journals using Scopus and Google Scholar. An initial sample of 41 literature sources yielded 39 published or unpublished articles and 2 recent PhD theses.

Given that our research focus is on the correlation of board size and firm performance, Each article was then checked against the six criteria, specified as follows:

(1) The paper is not an earlier version of another paper included in our sample;
(2) The paper is an empirical study that includes either a regression or a correlation analysis, as long as the impact size is estimable;
(3) The sample used in the empirical research must be a cohort of Islamic banks , or have an Islamic cohort, whose effect size are reported separately and can be obtained. Thus, our sample includes articles on Islamic banks as well as Islamic financial institutions;
(4) Corporate governance mechanisms must be a separate variable and must be identifiable;
(5) The paper only focused on using financial performance related measures as the dependent variable.
(6) The full text of the article must be obtainable.

Applying the above six criteria, resulted in twelve articles (Table 2).

Coding and analysis

Two main types of data are encountered in the sample: correlation coefficients with sample size, and regression results (either a t-statistics or p-value) with sample size.

The data were analysed using a commercial coding package, Comprehensive Meta Analysis . The build-in functions and consistency in correcting estimation errors exempt the coding from human calculation errors. The Hedges and Olkin (1985) (HOMA) procedure is computed in STATA12SE environment. Observations with missing values on either the corporate governance variable or financial performance variable are dropped.

HOMA procedure

Pearson product-moment correlation coefficient r and partial correlation coefficient $r_{xy,z}$ are commonly used in meta-analysis, given that they are scale-free, can be easily interpreted and computed, eg. using the HOMA procedure in STATA. Only studies in which performance variables are dependent variables are partial coefficients calculated . In our study, when multiple measures of firm performance are provided, all the available measurements from the sample were included in the study. In order to account for the differences in precision across effect sizes and variability in the population, the HOMA procedure, which treats the inverse variance weight was the optimal measure of precision for a given effect size. These weights will help to produce appropriate estimates for the meta-analytic mean effect size (van Essen and Oosterhout et al. 2012). The HOMA procedure will be used to estimate Hypothesis 1-12.

A mapping between the selected literature and effect sizes of corporate governance mechanisms is shown in Table 3.

Table 2 Studies included in the meta-analysis

Citation	Financial performance measure	Corporate governance measure	Publish Type	Year	Cross-sectional	Data collection	Country	Data-Year	N
Muttakin, M., H. Arouri, et al. (2011)	ROA(EBIT)	Ownership concentration, Foreign ownership, Institutional ownership, board size, CEO duality	Journal article	2011	1	Database	GCC countries	2008	27
Bino, A., and Tomar, S. (2012)	ROA, ROE, Total assets, Loans loss provisions ratio	board of directors' composition, managerial ownership percentage, board of directors' ownership percentage, board size	Journal article	2012	0	Database	Jordan	1997-2006	140
Al-Saidi, M. and B. Al-Shammari (2013)	ROA, Tobin's Q	Non-executive director, family directors, role duality, board size, ownership concentration	Journal article	2013	0	Database	Kuwait	1996-2010	45
Safieddine, A. (2009)	Total assets, Market capitalization, total revenue, revenue growth, net profits, net profit growth, 12 months index-adjusted returns, 6 months index-adjusted returns, price to earnings ratio, price to book ratio	Corporate governance index	Journal article	2009	1	Survey	GCC countries		29
Zouari, S. B. S. and N. B. Taktak (2012)	Debt ratio, Capital adequacy ratio, total assets	Ownership structure	Working paper	2012	0	Database	Global	2005-2009	265
S., A. and W. A., Boustancy (2008)	Net profit	Ownership structure, CEO duality	Journal article	2008	0	Database	MENA	1998-2003	89

Table 2 Studies included in the meta-analysis (Cont'd)

Citation	Financial performance measure	Corporate governance measure	Publication Type	Year	Cross-sectional	Data collection	Country	Data-Year	N
M., A. (2012)	ROA, Loan loss reserves to gross loans, loan loss provisions to gross loans, equity to total assets, total assets, liquidity to total assets	Shari"ah supervisory board size, percentage of SSB members with top twenty rankings, SSB composition changes or not	Unpublished work	2012	0	Database	Global	2000-2010	521
Abbas, S. Z. B. M., R. A. Rahman, et al. (2009)	Non-performing loans, ROE	Ownership structure	Conference paper	2009	0	Database	Malaysia	2000-2006	200
Adnan, M. A., S. N. N. Htay, et al. (2011)	Efficiency (Non-performing loans to total loans; operating expense to total assets)	Board independence, board size, ownership structure	Journal article	2011	0	Database	Malaysia	1996-2005	108
Al-Tamimi, H., H. A., et al. (2013)	Risk-weighted assets/total assets	Ownership structure	Journal article	2013	0	Database	UAE	1998-2010	52
Bukhari, K. S., M. A. Hayat, et al. (2013)	Financial performance	Auditing, Board of directors, SSB	Journal article	2013	0	Survey	Pakistan		36
Al Manaseer, M. F., R. M. Al-Hindawi, et al. (2012)	ROA, ROE, Profit margin, Earnings per share	Board independence, board size, ownership structure, CEO duality	Journal article	2012	0	Database	Jordan	2007-2009	45

Table 3 Articles including effect size for each of the corporate governance mechanisms

Citation	Board independence	Shari"ah Supervisory Board	Board size	CEO duality	Ownership Structure	Auditing
Muttakin, M., H. Arouri, et al. (2011)			X	X	X	
Bino, A., and Tomar, S. (2012)			X		X	
Al-Saidi, M. and B. Al-Shammari (2013)	X		X	X	X	X
Safieddine, A. (2009)	X	X	X	X		
Zouari, S. B. S. and N. B. Taktak (2012)					X	
S., A. and W. A., Boustancy (2008)					X	
M., A. (2012)		X		X		
Abbas, S. Z. B. M., R. A. Rahman, et al. (2009)					X	
Adnan, M. A., S. N. N. Htay, et al. (2011)	X	X			X	
Al-Tamimi, H., H. A., et al. (2013)					X	
Bukhari, K. S., M. A. Hayat, et al. (2013)		X	X			X
Al Manaseer, M. F., R. M. Al-Hindawi, et al. (2012)	X		X	X	X	

Note:X – the article has been included to abstract effect sizes. Blank cells indicate that the corresponding article was no included in the meta-analysis of the corresponding corporate governance mechanism.

Results

The hypotheses test results are shown in Table 4 in the Appendix. The effect size, number of articles and meta-analyses results were reported in Table 3-4. Hypotheses 1-4, 7-10 and 12-13 have to be accepted. Hypotheses 5, 6, 11 have to be rejected. Hypothesis 12 was not statistically significant.

Table 4 Meta-analysis results

Predictor	K	N	Effect size	z	p	CI 95%	Q test
Board independence	15	625	0.15	5.98	0.000	0.100/0.201	180.87(0.00)
Shari"ah Supervisory Board	32	4739	0.11	2.86	0.004	0.033/0.177	432.51(0.00)
Board size	21	922	0.08	3.43	0.001	0.035/0.126	99.47(0.00)
CEO duality	19	705	0.11	1.97	0.049	0.000/0.222	90.05(0.00)
Auditing	12	355	1.06	2.13	0.033	0.013/0.301	78.98(0.00)
Ownership structure	44	6010	-0.23	17.34	0.000	-0.252/-0.201	16177.19(0.00)
Blockholding	7	442	-0.82	2.03	0.000	-1.608/-0.030	476(0.00)
Director ownership	4	496	-0.76	16.75	0.000	-0.850/-0.672	1522.581(0.00)
Family ownership	5	976	0.827	25.63	0.000	0.764/0.890	1947.04(0.00)
Foreign ownership	10	1164	-0.603	20.30	0.000	-0.661/-0.544	812.40(0.00)
Government ownership	6	1065	0.877	28.39	0.000	0.817/0.938	2078.15(0.00)
Institutional ownership	10	1499	-0.992	38.03	0.000	-1.043/-0.941	5522.89(0.00)
Management ownership	2	280	-0.078	-1.286	0.199	-0.196/0.041	0.085(0.771)

FINDINGS AND DISCUSSION

The meta-analyses shows that Islamic banks tends to have better financial performance if (1) a higher proportion of independent directors on the board; (2) Shari"ah Supervisory Board is larger and is consist of top scholars; (3) more directors sitting on the board; (4) CEO is also the chairman of the board of directors; (5) internal and external auditing are enforced and (6) ownership structure were more dispersed, directors' shareholding were reduced, foreigners shareholding were reduced, institutional investors' shareholding were reduced, while family and governments' shareholding were increased. (7) Managers' shareholding was insignificant.

The summary of the statistical hypotheses and the test results are listed in Table 5.

Table 5 Comparison of statistical hypothesis and test results

Hypothesis No.	Corporate governance mechanism	Hypothesized sign	Test result
1	Board independence	+	0.15***
2	Shari"ah Supervisory Board	+	0.11***
3	Board size	+	0.08***
4	CEO duality	+	0.11*
5	Ownership structure	+	-0.23***
6	Blockholding /Concentrated ownership	+	-0.82***
7	Director ownership	-	-0.76***
8	Family ownership	+	0.827***
9	Foreign ownership	-	-0.603***
10	Government ownership	+	0.877***
11	Institutional ownership	+	-0.992***
12	Management ownership	+	-0.078
13	Auditing	+	1.06*

Four of the thirteen statistical hypotheses (highlighted in Table 5), namely ownership structure, blockholding, institutional ownership and management ownership contradict our hypotheses. The synthesise of the previous literature shows that a dispersed ownership structure, rather than a concentrated one, regardless of the blockholding of family, institutions, government, foreigners, managers, directors, is favourable for financial performance of Islamic banks, which is reconfirmed by the results on blockholding. The meta-analysis results indicate that less institutional ownership results in better financial performance, which is contradictory to the widely accepted evidence in the research into conventional banks. The role institutional ownership plays merits further investigation. Management ownership is not significant.

Limitations of the study

As with every meta-analysis, this study is subject to limitations. Some limitations are inherent in the primary studies. For example, all studies included in our meta-analysis exclusively examine surviving firms, and none corrected for survival bias. In addition, attempting to trace the validity and credibility of the data as well as analytical strategies used in the original studies is a 'mission impossible'.

Moreover, the systematic review of the major database also flags a number of concerns for the researchers, listed as follows:

i. Corporate governance in Islamic banks suffers from having a shadowy existence in business and economics. Articles reviewed here are mostly published in niche journals. Over the past decade, Islamic banks have come to the fore and academic research has increasingly attempted to understand how those banks differ from their conventional counterparts. However, most efforts have been devoted to comparisons between the Islamic banking and Conventional banking sectors, while studis

purely focusing on Islamic banks rarely appear in top journals in Economics, Finance and Management disciplines.

ii. Lack of a systematic solid evidence base left the Islamic bank related corporate governance research in an impasse of conceptualisation. Only two studies out of twelve in the review have a sample size larger than 200, albeit some are still using logit and probit models to test statistical hypothesis. The robustness of the empirical results has to be cross-validated in order to obtain a stable and parsimonious model.

iii. The data on corporate governance of Islamic banks is at a dearth. It will be a luxury for researchers if future endeavours should attempt to develop an objective and reliable database with corporate governance data for Islamic banks worldwide.

iv. Collaboration and communication among Islamic bank researchers and practitioners should be reinforced. The reviewer articles flagged the issues that there are overlaps in the research topic but the story may conflict and not be comparable because of the use of different data sources.

Future research efforts can be devoted to the establishment of an Islamic corporate governance database, a singular focus on the analysis of the impact of corporate governance on financial performance of the Islamic banking sector, and an in-depth investigation of the role institutional investors and management ownership play in the governance of Islamic banks.

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