THE CONTENT OF ACCOUNTABILITY IN CORPORATE GOVERNANCE

NATALYA MOSUNOVA,
Adecco Group Russia (Moscow, Russia)

Accountability is quintessence of any corporate governance debate despite that there is no unified doctrine what accountability consists of. Academics, politicians and businessmen advocate different categories as the foundation of this doctrine. To some extent this diversity can be explained by an eternal conflict of agency and stakeholder theories in corporate law.

This essay examines such aspects of corporate accountability as accounts and financial reporting, compliance to certain efficiency indicators and stakeholders' interests including moral values, their roles for various groups of stakeholders.

For these purposes author analyses the development of agency and stakeholders' theories in regard to financial reporting, provides evidences of stakeholder accountability in case law and legislation are provide and identifies difficulties of stakeholder accountability. It is argued that there is no universal definition of efficiency as a type of accountability and it may be defined through risk management and internal control systems only. Morality is also an ambiguous category for corporate accountability originated rather from political science than jurisprudence and may be used only like supplementary remedy.

That analysis allows justification of the absence of conflict between different definitions of accountability, inextricably links between them and their joint application as a guarantee of the achievement of accountability objectives.

Key words: corporate accountability; corporate governance; stakeholders; stakeholder interests; social responsibility; agency theory; stakeholder theory; morality; mechanism of stakeholder accountability.

1. Introduction

Corporate accountability is a continuation of confrontation between agency and stakeholder theories. Agency problem was highlighted as a central conflict of interests between shareholders and managers in listed companies.[1] Since the House of Lords' decision in *Salomon v. Salomon*[2] set that 'the shareholders are residual interest holders in the company,'[3] shareholders were considered as the dominant group to discharge corporate accountability to. Corporate governance policy documents and codes of practice in states of Anglo-American model visibly protect shareholder wealth, for example, the Cadbury Report (1992) in the UK. However other legal systems (German, Japanese) demonstrate benefits of the stakeholders' model both for a companies' success and the development of society.

Accountability is an instrument for controlling agency costs: the less the companies' accountability the higher risk that managers serve themselves. The problem, formulated seventy years ago by Berle and Means,[4] still exits. On the one hand, no one instrument is efficient if managers are not accountable to shareholders. On the other hand, modern markets often cause managers to consider society's interests too. Moreover, some governing bodies believe that not only 'shareholders are the constituent to whom they are accountable.'[5] The lack of a unified concept of liability generates various approaches to the concept of accountability.

2. Accounts and Financial Reporting

2.1. Financial Reporting as an Attribute of Agency Theory

Most 'accounting and finance research in corporate governance has focused on Anglo-Saxon stock markets . . . reflecting the traditional dominance of agency theory.'[6] Following this concept, accountability is interpreted only as corporate accountability to shareholders[7] because transparency in the form of disclosures to shareholders is an important mechanism for balancing shareholder and management interests. These studies examined the influence of board on its effectiveness and their

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1 Adolf A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45(8) 45 Harv. L. Rev. 1365 (1932).

2 *Salomon v. Salomon*, [1897] AC 22 (HL).

3 David Kershaw, Company Law in Context: Text and Materials 175 (2nd ed., Oxford University Press 2012).

4 Larry E. Ribstein, *Accountability and Responsibility in Corporate Governance* 4 (University of Illinois College of Law, Law and Economics Working Paper No. 34 (2005)), available at <http://law.bepress.com/uiuclwps/art34> (accessed Aug. 6, 2014) [hereinafter Ribstein, *Accountability and Responsibility*] (with reference to Adolf A. Berle & Gardiner Means, *The Modern Corporation and Private Property* (Transaction Publishers 1932)).

5 Paul M. Collier, *Stakeholder Accountability: A Field Study of the Implementation of a Governance Improvement Plan*, 21(7) Auditing & Accountability Journal 933, 936 (2008).

6 Niamh M. Brennan & Jill F. Solomon, *Corporate Governance, Accountability and Mechanisms of Accountability: An Overview*, 21(7) Accounting, Auditing and Accountability Journal 885, 889 (2008), available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2257451> (accessed Aug. 6, 2014).

7 *Id.* at 888.

consequences for shareholder value. For example, dependence of top management turnover (a measure of board effectiveness) and financial performance (a measure of management effectiveness) is justified.[8]

In terms of accounts and financial reporting accountability may be discussed in two ways: report transparency or the quality of financial reporting confirmed by audit committees.[9] This though does not exclude the other conflict of interest. For example, in the USA financial reporting rules for companies are established by Financial Accounting Standards Board, privately funded by major accounting firms.[10] Conflicts arise when, firstly, these major firms are invited to consult companies which are under their audit, secondly, when 'auditors are effectively chosen by the management of audited companies rather than by shareholders'[11] and, thirdly, between auditor's role of financial control and profits of the audited firms.

2.2. Financial Reporting and Stakeholders' Influence

This focus on agency theory does not prevent governance issues because the modern public company is involved in human and economic relationships and far more complex than that posited by the traditional shareholder model.[12]

The decision in case *ASIC v. Healey & Ors.*[13] Federal Court of Australia proves that financial reporting is perceived wider than just accountability to shareholders. In October 2009, the Australian Securities and Investment Commission [hereinafter ASIC] commenced proceedings against directors of the Centro entities. ASIC sought declarations that each of the defendants had breached their statutory duty of care and diligence owed to the Centro entities in approving consolidated financial accounts for the Centro entities for the financial year ending 30 June 2007. In this case the court found the board and every director (not audit committee) responsible for the accuracy of financial reports which once again proves the relevance of financial

8 Jay Dahya et al., *The Cadbury Committee, Corporate Performance, and Top Management Turnover*, LVII(1) The Journal of Finance (2002), available at <http://www.krannert.purdue.edu/faculty/mcconnell/publications/PublicationsPDFS/Cadbury...Turnover%20JF%20Feb2002%20V57%20N1%20461-483.pdf> (accessed Aug. 6, 2014).

9 Andrew Keay, *Ascertaining The Corporate Objective: An Entity Maximisation and Sustainability Model*, 71(5) The Modern Law Review 663 (2008), available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1889236> (accessed Aug. 6, 2014).

10 Fred R. Kaen, A Blue Print for Corporate Governance: Strategy, Accountability, and The Preservation of Shareholder Value 53 (AMACOM 2003).

11 *Id.* at 54.

12 Keay, *supra* n. 9, at 666 (with reference to Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70(3) Tex. L. Rev. 579, 630 (1992), available at <http://scholarlycommons.law.case.edu/cgi/viewcontent.cgi?article=1382&context=faculty_publications> (accessed Aug. 6, 2014)).

13 *ASIC v. Healey & Ors.*, (2011) ALR 618.

statements for accountability. As plaintiff in the lawsuit is ASIC, not shareholders, a company is financially accountable to shareholders and stakeholders alike.

Stakeholder role in financial results is also confirmed by latest research demonstrating that financial accountability based 'on shareholder primacy produces a short-term focus and short-term earnings'[14] only.

Consequently, stakeholders' influence increases even in this form of accountability which has traditionally been addressed to shareholders.

3. Social Responsibility and Accountability

3.1. Stakeholders Theory

Recently authors have noticed that there has been a change of emphasis, away from the traditional shareholder-centric approach towards a more stakeholder oriented approach to corporate governance.[15] E. Merrick Dodd, Jr, Berle's opponent, declares that 'a sense of social responsibility toward employees, consumers and general public may thus come to be regarded as the appropriate attitude'[16] for companies which should act. Professor Parkinson encourages the idea of a company's socially responsible behaviour[17] but does not give criteria of socially responsible acts which would allow defining the scope of company accountability to stakeholders. In 1992 Hill and Jones proposed a stakeholder-agency theory. In contrast to agency theory, in which managers represent shareholders (principals) who hired them, this theory shows managers are the only stakeholders who are agents to all other stakeholders.[18] Stakeholder-agency theory justifies the accountability of the board to multiple stakeholders, prioritising explicitly or implicitly the different (rather than competing) interests of those stakeholders. The relative power, legitimacy and urgency of stakeholder claims are factors that can change over time[19] although other researchers warn of possible systematic exclusion, silencing and disempowerment of stakeholders by a powerful board.[20]

One of the stakeholders' approach proponents Freeman defines a stakeholder as 'any group or individual who can affect or is affected by the achievement of an

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14 Keay, *supra* n. 9, at 671 (with reference to Steven M.H. Wallman, *The Proper Interpretation of Corporate Constituency Statues and Formulation of Director Duties*, 21 Stetson L. Rev. 163, 176 (1991)).

15 Brennan & Solomon, *supra* n. 6.

16 E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45(7) Harv. L. Rev. 1145 (1932).

17 Kershaw, *supra* n. 3, 369 (with reference to John E. Parkinson, Corporate Power and Responsibility (Oxford University Press 1993)).

18 Collier, *supra* n. 5 (with reference to Charles W.L. Hill & Thomas H. Jones, *Stakeholder-Agency Theory*, 29 Journal of Management Studies 131 (1992), available at <http://www.ensp.unl.pt/saboga/incentivos/texto_02.pdf> (accessed Aug. 6, 2014)).

19 Collier, *supra* n. 5.

20 *Id.*

organisation's objectives.'[21] Thus stakes are held in the organization by employees, customers, suppliers, financiers, government and the community.

3.2. Reflection of Stakeholder Accountability in Legislation. Guidelines on Shareholders' and Stakeholders' Interests

Attempts of legislators to take into account stakeholder accountability even in the Anglo-American system confirm the new tendency. For example, shareholders and stakeholders interests are protected in sect. 717(b) New York Business Corporation Law:

> (b) In taking action, including, without limitation, action which may involve or relate to a change or potential change in the control of the corporation, a director shall be entitled to consider, without limitation,
> (1) both the long-term and the short-term interests of the corporation and its shareholders and
> (2) the effects that the corporation's actions may have in the short-term or in the long-term upon any of the following:
> (i) the prospects for potential growth, development, productivity and profitability of the corporation;
> (ii) the corporation's current employees;
> (iii) the corporation's retired employees and other beneficiaries receiving or entitled to receive retirement, welfare or similar benefits from or pursuant to any plan sponsored, or agreement entered into, by the corporation;
> (iv) the corporation's customers and creditors;
> (v) the ability of the corporation to provide, as a going concern, goods, services, employment opportunities and employment benefits and otherwise to contribute to the communities in which it does business.[22]

UK Companies Act 2006, sect. 172, put interests of company's employees, suppliers and customers as criteria for director's duty to promote the success of the company setting that:

> (1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to –
> (a) the likely consequences of any decision in the long term,
> (b) the interests of the company's employees,

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[21] R. Edward Freeman, Strategic Management: A Stakeholder Approach 46 (Pitman 1984).

[22] <http://codes.lp.findlaw.com/nycode/BSC/7/717#sthash.jM3Vmqsk.dpuf> (accessed Aug. 6, 2014).

> (c) the need to foster the company's business relationships with suppliers, customers and others,
> (d) the impact of the company's operations on the community and the environment,
> (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
> (f) the need to act fairly as between members of the company.[23]

American Law Institute's Principles of Corporate Governance defines social responsibility duties:

> Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business . . . (2) May take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and (3) May devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.[24]

Consequently, 'managers are not subject to liability for breach of fiduciary duty if they devote "reasonable" resources to public welfare and similar purposes even if corporate profit and shareholder gain are not thereby enhanced.'[25]

The most influential organisations advocated stakeholders interests in corporate accountability suggest a variety of codes and principles to reconcile stakeholder and shareholder theories. For example, Organisation for Economic Co-operation and Development (OECD) published in 1998 report on *Corporate Governance: Improving Competiveness an Access to Capital in Global Markets*[26] which recognizes that 'different societal pressures and expectations may impact on the financial objective.'[27] One of the largest UK institutional investors Hermes published in 2002 *The Hermes Principles* which states in Principle VIII Relationship with Stakeholders:

> Companies should manage effectively relationships with their employees, suppliers and customers and others who have a legitimate interest in their

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23 <http://www.legislation.gov.uk/ukpga/2006/46/pdfs/ukpga_20060046_en.pdf> (accessed Aug. 6, 2014).

24 American Law Institute, Principles of Corporate Governance, § 2.01(b).

25 Ribstein, *Accountability and Responsibility*, *supra* n. 4 (with reference to Larry E. Ribstein, *The Mandatory Nature of the ALI Code*, 61 Geo.Wash. L. Rev. 984, 1000–02 (1983)).

26 Available at <http://www.oecd-ilibrary.org/industry-and-services/corporate-governance-improving-competitiveness-and-access-to-capital-in-global-markets_9789264162709-en;jsessionid=2sap4dlikfuf4.delta> (accessed Aug. 6, 2014).

27 Christine A. Malin, Corporate Governance 73 (4th ed., Oxford University Press 2013).

> activities with a view to maximising long-term shareholder value. Well managed companies cannot ignore the impact of their activities on the wider society. This does not mean however, that businesses have limitless social obligations. It is the responsibility of businesses to generate value for long-term shareholders. Hermes believes that they will only be able to do so in the long-term by effectively managing relations with their key stakeholders.[28]

Thus, actually companies became accountable to all stakeholders groups even in states which traditionally maintained a shareholder-centric model.

3.3. Mechanism of Stakeholder Accountability

Traditional mechanisms of accountability are presented by:

- governance regulations;
- boards of directors;
- financial reporting and disclosure;
- audit committees;
- external audit;
- institutional investors.[29]

A more stakeholder-oriented approach causes a greater focus on financial services accountability to a broader range of stakeholders, for example, to institutional investors.[30] Thus, financial reporting increases its value in this model.

Environmental, social and governance aspects constitute other elements of mechanism of stakeholder accountability. Accountability of corporate governance to employees[31] also plays as an essential role for corporate governance.

Partnership between capital and some stakeholder groups is used for years in Germany and France where employees and banks are represented in the board which gives additional incentives for development of governance systems.[32] Japanese corporate system is interpreted as prioritizing interests of employees above shareholders' interests. This fact was interpreted as employees' privileges in expenses of shareholders, 'which is now commonly argued to be an indicator of poor

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28 The Hermes Responsible Ownership Principles: What We Expect of Listed Companies and What They Can Expect of Us <http://www.hermes.co.uk/Portals/8/The_Hermes_Ownership_Principles_UK.pdf> (accessed Aug. 6, 2014).

29 Brennan & Solomon, *supra* n. 6.

30 A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment. Produced for the Asset Management Working Group of the UNEP Finance Initiative (October 2005), <http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf> (accessed Aug. 6, 2014).

31 Prem Sikka, *Corporate Governance: What About The Workers?*, <http://www.essex.ac.uk/ebs/research/working_papers/WP_07-02.pdf> (accessed Aug. 6, 2014).

32 Malin, *supra* n. 27, at 78.

corporate governance,'[33] however, strong commitment of Japanese employees to their companies provided incredible economic growth and outstanding corporate culture in this country.

3.4. Difficulties of Stakeholders' Accountability

Proponents propose to enhance accountability by giving more power to non-owner stakeholders, for example, to let employees vote equally with shareholders;[34] the European system of codetermination gives employees some representation on the board.[35] However such radical reforms entail obvious undesirable costs and difficulties because:

1) these changes 'could significantly increase the stakeholders' ability to extract wealth from shareholders'[36] and the problem of shareholder opportunism to stakeholders would transfer to a more serious problem of stakeholder opportunism to shareholders;

2) stakeholders may not benefit significantly from such radical changes because group internal disagreements in each stakeholder group will likely reduce its influence to zero;[37]

3) even if stakeholders' benefits compensate shareholders' loses a company may suffer from inefficiency of a new form of governance because managers responsibility 'either to multiple constituencies or to specific constituencies (such as employees) with multiple internal objectives'[38] may increase agency costs.

Practical concerns regarding implementation of stakeholders' accountability is due to inability of courts to make distinctions between judgments that are, and are not, in the corporation's or shareholders' interests despite that it is usually clear whether business judgments are in the managers' own interests or that completely disregard corporate interests.[39] As standards of stakeholder accountability are not defined there is a risk that courts will imply shareholder wealth maximization as the only measure.

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[33] Simon Learmount, Corporate Governance: What Can Be Learned From Japan? 147 (Oxford University Press 2002).

[34] Ribstein, *Accountability and Responsibility*, *supra* n. 4, at 8 (with reference to Marjorie Kelly, The Divine Right of Capital: Dethroning the Corporate Aristocracy (Berrett-Koehler Publishers 2001)).

[35] Reinier Kraakman et al., The Anatomy Of Corporate Law: A Comparative And Functional Approach 65 (2nd ed., Oxford University Press 2009).

[36] Alan J. Meese, *The Team Production Theory of Corporate Law: A Critical Assessment*, 43(4) Wm. & Mary L. Rev., available at <http://scholarship.law.wm.edu/cgi/viewcontent.cgi?article=1481&context=wmlr> (accessed Aug. 6, 2014).

[37] Ribstein, *Accountability and Responsibility*, *supra* n. 4.

[38] *Id.*

[39] *Id.*

For example, in the famous case of *Shlensky v. Wrigley*[40] the social responsibility issue fades into the business judgment rule: the court dismissed a complaint of the minority shareholders to install evening light. The main shareholder explained his position by preventing surrounding neighbourhoods from deteriorating effect of night games. The court reasoned:

> [W]e are not satisfied that the motives assigned to Philip K. Wrigley, and through him to the other directors, are contrary to the best interests of the corporation and the stockholders. For example, it appears to us that the effect on the surrounding neighbourhood might well be considered by a director who was considering the patrons who would or would not attend the games if the park were in a poor neighbourhood. Furthermore, the long run interest of the corporation in its property value at Wrigley Field might demand all efforts to keep the neighbourhood from deteriorating. By these thoughts we do not mean to say that we have decided that the decision of the directors was a correct one. That is beyond our jurisdiction and ability. We are merely saying that the decision is one properly before directors and the motives alleged in the amended complaint showed no fraud, illegality or conflict of interest in their making of that decision.[41]

In other words, the court did not take into account social responsibility and dismissed the complaint just because the subject of the dispute was outside its jurisdiction in this case and it was no 'fraud, illegality or conflict of interest.'[42] Thus stakeholder accountability is not the main constrain of managers in U.S. model where they still have 'significant discretion within that standard to help themselves, stakeholders or shareholders, as they prefer.'[43]

4. Accountability and Efficiency

There is no universal understanding of efficiency in corporate accountability.

The UK Corporate Governance Code 2012 in Code Provision C. 2.1 establishes that 'the board should, at least annually, conduct a review of the effectiveness of the company's risk management and internal control systems and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls.'[44] Consequently,

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40 95 Ill. App.2d 173, 237 N.E.2d 776 (1968).

41 *Id.*

42 Ribstein, *supra* n. 4.

43 *Id.*

44 <http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx> (accessed Aug. 6, 2014).

efficiency may be defined through risk management and internal control systems and shareholders like addressees of this accountability. However, reporting to shareholders would be too narrow because 'interests of shareholders and stakeholders are often intertwined [and] the distinction between shareholders and stakeholders is often not clear-cut'[45] because shareholders may derive from other stakeholders groups like pension funds and insurance companies.

Economists determine accountability in regard with 'true value of a company which investors will pay . . . based on all of its expected future returns to its owners'[46] and use the following market indicators:

1) weak-Form Efficiency as 'knowledge of past price changes does not help in predicting deviations from expected future price changes;'[47]

2) semi-strong form efficiency which means publicly available information including 'news release about earnings, cash dividends, new product ventures'[48] *etc.*;

3) strong-form-efficiency which incorporates 'private as well as public information in security prices.'[49]

It is believed that this type of accountability is an indicator that managers 'are running the company in the long-term best interests of the shareholders' however it may be useful for stakeholders as well as the grounds for investment decisions to the particular pension fund or acceptance of job-offer for the candidates.

5. Accountability and Morality

The idea of corporate moral accountability is becoming more and more popular due to political reasons. Not only anti-globalization activists but also academics argue that corporation 'can be subject to moral responsibilities and . . . they should be.'[50] In the United Kingdom the popularity of this type of accountability has caused, firstly, Thatcherite reforms and, secondly, globalizations tendencies according to which multinational corporations and international organisations are more influential than national governments. However there is no intelligible concept of corporate moral accountability and its connection with legal responsibilities of corporations and social responsibility. Melissa Lane assumes as 'a working hypothesis that conception of accountability display family resemblances – one drawing on ideas of answerability, responsibility and sometimes scrutiny and sanctions – in the

45 Malin, *supra* n. 27, at 78.

46 Kaen, *supra* n. 10, at 34.

47 *Id.* at 35.

48 *Id.* at 38.

49 Id. at 43.

50 Melissa Lane, *The Moral Dimension of corporate Accountability*, in Global Responsibilities: Who Must deliver on Human Rights? 229 (Andrew Kuper, ed.) (Routledge Taylor & Francis Group 2005).

various contexts in which they arise.'[51] Proponents of moral accountability justify the essential of moral accountability in developed states by legal context insufficiency because the laws may be out of date or 'do not demand accountability for certain wrongs that corporations do.'[52]

Nevertheless moral accountability is still an ambiguous category both in content and subject of responsibility. As a corporation cannot be accountable to itself (what is presumed for moral responsibility) moral accountability often merges with social responsibility. On the other hand, as a corporation as an artificial legal form, its moral accountability derives from representatives acting in its name, but not all moral duties of natural persons become corporate accountability.

The main argument why corporations may be morally accountable is that 'is not impossible for them to do so'[53] what is not substantively. Thus, the study on moral accountability is rather from political science that jurisprudence and may be applied like supplementary instrument to legal and social accountability only.

6. Conclusion

The heart of corporate government is definitely accountability. Lawyers, economists and political scientists continue this discussion. However, the stepping-stone of accountability is an imaginary confrontation of stakeholder and shareholder theories. Most theorists agree that the shareholders should have a more important role in governance than other stakeholders. The analysis has demonstrated that, firstly, financial reporting, stakeholder accountability and efficiency are inextricably linked and are essential in relationship with between shareholders and stakeholders. Moreover, sometimes it is impossible to separate stakeholders' and shareholders' interests in the modern economy because they move from one group to another. Secondly, no one aspect constitutes an all-sufficient approach to the content of accountability and obliging force of its elements, every concept has its own story of success and drawbacks, for example, like stakeholder economy in some states.

Thus contrasting of different accountability theories is artificial: only comprehensive use of all instruments makes a company truly accountable. That is why even fairly conservative corporate systems began moving towards the recognition of all accountability elements discussed in this essay including social responsibility, as evidenced by changes in legislation, court decisions and governance principles proposed by influential organizations. The best experience of all models and different jurisdictions may benefit corporate governance and community in different countries.

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51 *Id.* at 232.

52 *Id.* at 233.

53 *Id.* at 239.

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Information about the author

Natalya Mosunova (Moscow, Russia) – Head of Legal Department, Adecco Group Russia (2/3 Paveletskaya sq., Moscow, 115054, Russia; e-mail: natalia.mosunova@adecco.com).