Assurance Services as a Substitute for Law in Global Commerce

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Governance at the “boundaries” of firms

- In previous work with Lynn Stout, she and I have studied the internal governance of corporations.
- We argued that the internal hierarchy of a corporation exercises decision-making control over transactions “within” the firm.
- Firms also engage in transactions – and even long-term contracts – with parties “outside” the firm.

How are such transactions governed or enforced?

- Contracts
  - Enforceable by law
- Norms and reputational concerns
  - Self-enforcing?

What about in “global” context, where law is weak or unavailable?

- Reputational concerns and norms may work for high visibility firms, with valuable brands to protect.
- But may not work with smaller, younger, less visible firms, with less invested in brand.
  - Competition on basis of low labor costs, without regard to how workers are treated.
  - Intellectual property rights may not be respected.

In such environments, alternative enforcement mechanism may be needed:

Third Party Assurance Services

Idea is not new.

- Goes back at least to mid-19th Century.
- Trading companies sought to insure cargoes of goods bound for international trade.
- Insurance companies, in turn, hired inspectors to testify to seaworthiness of ships.
- Customs officials also hired inspectors to attest to nature and quantity of cargoes.
- E.g., Registro Italiano Navale (RINA), had its beginnings some 150 years or more.

Most familiar and well-developed example of third-party assurance:

External Auditing Firms

Inspect and attest to appropriate methodologies in financial accounting

Other familiar examples:

- Title search firms.
- Hazardous materials inspectors.
- Underwriters’ Laboratories (seal of approval indicating electrical appliances are safe).

We speculate that, where rule of law is weak, business norms unreliable, and business practices erratic, third party assurance services may be rapidly becoming the dominant mechanism for enforcing contracts.

Third party assurance may also be an important mechanism for “social” regulation of business.

Organization of the paper:

I. Reasons why we think demand for third-party assurance is growing, perhaps explosively.
II. Evidence that third party assurance activity is increasing.
III. Potential tension between corporations and national sovereignty over private enforcement.
IV. Case study of China.

Bad news/good news

- We are just getting started, and have not yet found or constructed direct empirical evidence of growth in assurance business.
- But, in a very short time, we found a very large amount of anecdotal, circumstantial evidence!
- Our “evidence” section looks more like extension of our “reasons why” section.

Why is third party assurance becoming so important:

- Increased outsourcing, and extension of supply chain into all parts of globe.
- Complexity of products in international trade requires increased division of labor within supply chains.
- Firms are discovering that entire supply chain is exposed even to risks at individual links (E.g. chemical companies after Bhopal).
- More value tied to “brands” and reputation.
- Increasing sophistication of NGOs, activists, at exposing and publicizing environmental, human rights, and labor fairness and safety failures.

Evidence of expansion in third-party assurance

- International Standards Organization (ISO):
  - NGO with quasi-official status, operating since 1940s to issue standards for <u>products:</u> e.g. gold and other metal alloys, ceramics, electrical parts, grades of oil, grades of agricultural products.
  - In 1987, adopted "ISO 9000," standards for "management of quality": first set of international standards (other than in accounting) that applied to management <u>systems</u>, rather than to products.
  - ISO determines "Registrars." These firms are then qualified to train and approve of "certification bodies."
  - As of 2004, 29 international certification bodies; plus numerous certification bodies that operate in only one country, including, e.g. 39 in China alone.

Emergence of network of “certification bodies”

- In 1993, nearly 28,000 firms, plants, and facilities in 48 countries had earned ISO 9000 certification.
- By 2004, more than 670,000 sites and facilities in 154 countries had achieved ISO 9000 certification.
- No comparable then/now data on numbers of certifying bodies – but it’s hard to avoid conclusion that the business of certifying management systems has grown explosively.

Increasing standards throughout supply chain

- Global corporations require quality, timely delivery, and maybe safety, fair work practices, and appropriate environmental performance from their suppliers.
- Suppliers, in turn, beginning to require similar performance standards from their suppliers

Extension of idea of auditing management to idea of “social” auditing.

- Rapid proliferation in last 15 years of social, environmental, corporate governance standards.
- Similar growth in associated transparency standards.
- Important example: ISO 1400 (environnmental auditing standards).

Social performance examples:

- OECD Principles of Corporate Governance
- Responsible Care Initiative (chemical firms).
- SA 8000 (labor protections for apparel, toy mfg firms)
- WRAP (Worldwide Responsible Apparel Production)
- Voluntary Principles on Security and Human Rights (oil, gas, other extractive industries)
- World Business Council on Sustainable Development (group led by World Economic Forum).
- Business Roundtable: S.E.E. (society, environment, economy) Change.

Transparency examples

- Disclosure Guidelines on Socially-Responsible Investment (Association of British Insurers).
- Carbon Disclosure Project.
- Investors’ Network on Climate Change.
- Global Reporting Initiative.
- Rapid increase in global companies issuing “social” reports (52% of Global 250 companies in 2005).

Firms getting into the business:

- Major independent accounting firms (e.g. KPMG Sustainability.)
- Old ship-inspection firms (RINA, SGS, Intertek, DNV, etc.) adding social inspection to services they sell.
- New firms: Cal Safety Compliance Corp., Hong Kong Quality Assurance Agency, ALGI.

Does “third party” assurance threaten national sovereignty?

- E.g., private security forces, private contract enforcement mechanisms.
- Inducement to bribery and corruption.

On the other hand, examples of corporations encouraging democracy, rule of law:

- British Petroleum responded to bad publicity over accusations it collaborated with brutal local police by building Voluntary Principles on Human Rights and Security into contracts with local security providers. Also claims to be encouraging government initiatives to strengthen judiciary and rule of law.

China “case study”:

- Major apparel brands (Nike, Wal-Mart) accused of promoting “sweatshop” production in early 1990s.
- Branded apparel, shoe, toy companies developed codes of practice in late ’90s; suppliers supposed to meet them too.
- Since 2000, purchasing firms have begun insisting on “third party” inspection to assure best practices are followed.

Initial reaction:

- Chinese factory owners, government officials initially resisted.
  - Suppliers required to absorb costs.
  - Fee structure provided bad incentives – inspectors could be bribed
  - Inspectors were seen as naïve, and unprofessional.
  - In general, standards like SA 8000 were seen as a “non-tariff trade barrier.”

China’s reassessment:

- Since 2005, some shortages of labor have occurred in coastal factory areas, giving labor more bargaining power.
- Incidences of appalling conditions in factories making goods for domestic consumption have been publicized.
- Growing concern about social unrest, widening gap between rich and poor
- Labor representatives, intellectual elite, government officials now see third party inspection as a way to ensure China’s own labor laws are enforced.

“If you can’t beat ‘em . . .”

- Chinese government now formally embracing “corporate social responsibility.”
- Ministry of Commerce and seven other agencies developing “CSR” standards.
- (Google search on Chinese term for corporate social responsibility turns up more than 230,000 links.)
- China National Textile and Apparel Council has created Committee for Promotion of Corporate Social Accountability System for Chinese Textile Enterprises, and set of standards: CSC9000T.

Does this mean China is embracing developed-country norms and rule of law?

Or does it just mean that Chinese business leaders have discovered there is money to be made in the Third Party Assurance business?

Does it matter?