MASTERARBEIT

Titel der Masterarbeit

„CSR in Global Fashion Supply Chains with Respect to the Principal–Agent Model“

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angestrebter akademischer Grad
Master of Science (MSc)

Wien, 2014

Studienkennzahl lt. Studienblatt: A 066 915
Studienrichtung lt. Studienblatt: Masterstudium Betriebswirtschaft
Betreut von: Univ.-Prof. Dr. Stefan Minner
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<tr>
<td>A</td>
<td>Agent</td>
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<td>CoC</td>
<td>Code of Conduct</td>
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<td>CSR</td>
<td>Corporate Social Responsibility</td>
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<tr>
<td>EC</td>
<td>European Commission</td>
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<td>FAP</td>
<td>Full Audit Program</td>
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<td>FLA</td>
<td>Fair Labor Association</td>
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<td>GCC</td>
<td>Goal Congruency Correction Factor</td>
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<td>MNEs</td>
<td>Multi-national enterprises</td>
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<td>P</td>
<td>Principle</td>
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<td>PAM</td>
<td>Principle – Agent Theory</td>
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<td>SCC</td>
<td>Supplier Code of Conduct</td>
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<td>SSCM</td>
<td>Sustainable supply chain management</td>
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1. INTRODUCTION

“Sustainability is a key element of both our corporate values and our business idea of offering fashion and quality at the best price. Our industry faces a number of challenges – from the way we use natural resources to working conditions in supplier factories. Given our size, we have the opportunity to tackle these challenges by taking Conscious Actions and thereby make more sustainable fashion accessible and affordable to customers around the world.” [H&M, Conscious Actions Highlights, 2011]

“Because of their social and environmental initiatives the clothes producer recently received an award in Sweden, but here few weeks after the tune has changed, as H&M (Hennes & Mauritz) is accused for using child labor and paying substandard wages to their workers in Cambodia.” [www.scandasia.com, 2012]

The following chapter will give an introduction to the topic the thesis is dealing with. It will explain the aim, methodology and general deliberations of the research done in this thesis.

Apparel, textile and garment production has always been and will remain a labor-intensive exercise with small capital-investment requirements [Abernathy, 2006, p.2208]. Therefore as a result, developing countries have seen the export of apparel products as a major pathway of economic growth – offering products at lower costs due to cheap labor [DiSano, 2007, p.187]. Therefore international trade in the textile and clothing industry began to expand with more reliable shipping and cheaper production [Abernathy, 2006, p.2210]. So the trend was born in outsourcing production to low-cost suppliers instead of producing on their own or with the help of domestic suppliers [Kathawala, 2005, 187]. The number of supplier companies has risen to a horrendously large number and they are located all over the world. Referring to the textile and fashion industry, it can be seen that Global Sourcing\(^1\) has no boundaries [Bäumer, 2007, p.119]. Seen from a textile industry

\(^1\) **Global Sourcing:** With Global Sourcing a procurement strategy is understood, in which a business seeks to find the most cost-efficient location for manufacturing a product, even if the location is in a foreign country [Yu, 2008].
perspective, as highlighted in Figure 1, cotton was harvested in the USA, then shipped to China, where it gets processed and then to Turkey, where it gets colored and tailored before it comes to the final customer or fashion store.

![Figure 1: Example of a supply chain in the fashion industry](image)

As this example indicates, the supply chain of one product is distributed globally, and this highlights the significance of the alignment of the supply chain to its environment [McAdam/McCormack, 2001].

When someone enters a fashion store like H&M, Zara or Vero Moda and takes a simple shirt from the shelves, it can be easily explored where it was produced – usually tagged with Turkey, Asia, China or India. Though some people may ignore that fact, just being happy about the cheap price, others may wonder: “Who has sewn this shirt together? Under which circumstances was it produced?” A basic cotton T-shirt doesn’t seem quite so basic when you trace its life history.

\[\text{own representation}\]
As one of the most polluting and resource-devouring industries in the world, the production of clothes and garment is damaging the environment, and the supply chains are long and complicated [Hertwich, 2010]. As stated before, a t-shirt may easily have been on a round-trip around the world before it ends up at the end customer [Rivoli, 2005] and as a result of globalization, companies are becoming increasingly aware of social- and environmental aspects of production [Pedersen/Andersen, 2006]. So they have to confront themselves with the need to execute a production that is fiscally responsible as well as their responsibilities towards society in which they operate as stakeholders and governments [ita.doc.gov, 2012]. Further it can be seen that governments pay more attention to the poor working conditions in many developing countries [Brown, 2002]. This, together with several scandals within the clothing industry has extended the need and the importance to include the concept of Corporate Social Responsibility (CSR) in the company’s strategies of multinational companies within the fashion industry [Borreskov Juulsen/Knudsen, 2010]. Corporate Social Responsibility (CSR) is generally understood as voluntary initiative going beyond legislative requirements and contractual obligations [Mandl, 2005]. Countries have developed initiatives to motivate companies to adhere to certain guidelines, in order to show that they are responsible corporate citizens.

“This has resulted in increased pressure being placed upon […] [companies] to develop effective management systems across their supply chains dealing not only with issues of quality but also matters pertaining to the conditions under which many products are made such as working conditions in the countries from which […] [companies] purchase their products.” [Mamic, I., 2005, p.81]

A wide range of international organizations and business associations have introduced management standards, labeling schemes and reporting environmental aspects of production to overcome the problem of non-compliance of the business ethics within the supply chain [Kolk/Van Tulder, 2003]. Specifically the fashion industry is affected by these changes, as global supply chains, brand identity, customers’ perceptions and diverse and dispersed employment all constitute critical elements of building a sustainable competitive advantage [Da Graça Guedes/Roncha, 2010]. Therefore a large number of multinational companies (MNC’s) have introduced Code of Conducts (CoC) to improve the company’s social and environmental performance [Pedersen/Andersen, 2006]. But there exist several challenges to control these CoC [Pedersen/Andersen, 2006].
“Active commitment is a precondition for the successful implementation of the codes, but the incentive to comply with the codes does not necessarily extend to all the actors in the chain. Moreover, it is difficult to enforce codes of conduct in global supply chains, because the involved companies are separated geographically, economically, legally, culturally and politically.” [Pedersen/Andersen, 2006, p.228]

Looking at these conditions it may result in a non-compliance of a CoC [Pedersen/Andersen, 2006].

Realizing that non-compliance can have severe consequences for the Initiator or so-called supply chain watchdog\(^3\), companies have to find some mechanisms or incentives for aligning the supply chain with the terms of the codes [Pedersen/Andersen, 2006]. However, no best practice for working with CSR has been identified in this industry and companies are dealing with CSR in a myriad of ways with various degrees of success, otherwise NGOs would not reveal whether certain fashion companies live up to current laws in which they operate [Hopkins, 2004].

Despite the big efforts in order to audit its suppliers, companies have been involved in more than one scandal regarding the labor conditions of their workers:

- In 2003 a Zara’s supplier was involved in a Child Labor Scandal in Morocco [www.wharton.universia.net, 2003].
- In 2006 another Zara’s supplier was involved in a Child Labor Scandal in north of Portugal [www.theportugalnews.com, 2006].
- In 2010, at least 21 workers died and 50 were hurt when a fire swept through a Bangladeshi factory making clothes for budget retailer H&M [www.independent.co.u, 2010].

\(^3\) **Supply chain Watchdog**: Major dominant enterprise, that is powerful and has bargaining power, seeks to set the standards and to guide them according to the corporation’s values and expectations [Spence/Bourlakis, 2009].
• In 2011, nearly 300 Cambodian fainted attributed to poor working conditions, prompting an investigation by the clothing chain H&M. More than 100 people were hospitalized [www.independent.co.u, 2011].

• In 2012 Greenpeace has tested clothing from Bestseller Group brands Jack & Jones and Vero Moda and found to contain the substance NPE (nonylphenol ethoxylate) as when it is discharged into a water body decomposes into substance nonylphenol, which is dangerous for health and the environment [www.dmogt.dk, 2012].

But even though so many negative incidents have occurred and a lot of attention from the media was shown, evidence for decrease in sales is not obvious. Given the example Zara (brand of Inditex Group): the company has suffered a lot of scandals (read above) and even though it can be seen in the last years that the numbers were not dropping but “[…] actually followed a pattern of previous years when other labor scandals involving Zara were made public; as a matter of fact, the brand has been experiencing an average growth in sales of 10% per year since 2006. The explanation for this phenomenon could be the fact that the profile of consumers [the three fashion retailers are targeting] is not that type that would be concerned about social and environmental issues.” [Ishihara, 2012]

H&M, Bestseller and Inditex Group customers are those who care about trends and fast fashion. Buying the latest fashion and bringing it to CARITAS when it is no longer fashionable classify their behavior. Further, prices are reasonable enough that more money can be spent in following period. It is clear that these consumers are guided by short-term commitment and accessible pricing so they can own more, which makes them less likely to worry about the origin of a product [Ishihara, 2012].

On the other hand, shareholders have a different mind-set: the company’s reputation plays an important role on the stock market decision [Ishihara, 2012]. H&M and Inditex Group have to defend certain actions to the board and shareholders, while Bestseller is 100% family owned. Nevertheless Bestseller has stakeholders and certain investors who want the company to succeed. This might be a reason why fashion companies might engage into CSR activities. Having an increased environmental and social engagement shown by the upper management of a corporation obviously builds up a positive image to the general public. Even though profits have increased despite the scandals of all three companies, it can be reflected via the stock value e.g. Inditex’s stock, that they are not
entirely resistant to scandals: stocks value dropped 4.3% in the Madrid Stock Market, but soon rose again. [http://www.eoi.es, 2012]. This example shows why these scandals occur again and again. It seems to be obvious that proper-implemented CSR activity should be of high priority. Due to a lack of incentive, the companies do not fix it because it would require more effort, not necessarily more money.

1.1. Problem Formulation

“A recent survey by the World Bank estimates that there are 1,000 corporate codes existing today concerning labor, human rights, and environmental requirements for suppliers.” [Yu, 2008, p. 514]

“Many MNCs in various industries have established their own Supplier Codes of Conduct such as [...] [H&M, Bestseller and the Inditex Group].” [Kanchanavipu/Kucukcingoz, 2009, p. 4] The problem is that in the past it has been noticed that most CoCs suffer from a number of flaws [Kanchanavipu/Kucukcingoz 2009, Sethi, 2002].

So it has been observed that CoC are “presented as public statements of lofty objective and intent with lack of explicit content”. [Kanchanavipu/Kucukcingoz, 2009, p. 4]. Additionally some companies lack a serious implementation plan. “These codes of conduct, likewise, do not present any framework for supplier’s commitment or any incentive for suppliers.” [Kanchanavipu/Kucukcingoz, 2009, p. 4]

Given the risks for the “principal” or the “supply chain watchdog”, such as H&M, Inditex or Bestseller, to suffer a scandal, which has the biggest after-effects on them, causing decrease in their reputation and credibility, certain measurements have to be developed to maintain compliance.

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4 The following section refers to Kanchanavipu/Kucukcingoz, 2009
1.2. Research objectives and methodology

This thesis aims to address the mechanisms and drivers that result in responsible supplier behavior in a supply chain and its participants. It will present a conceptual framework for analyzing CSR practices and their safeguards in global supply chains. The aim is to answer the following derived questions according to the formulation of the problem:

i. Is there a relationship between the integration of the concepts of sustainability and economic success?

ii. What kind of incentives do suppliers need to be compliant?

iii. How do safeguard-mechanisms get implemented and managed in specific multinational fashion corporations?

In order to understand how CRS practices are implemented, a case study approach is chosen. Case study research excels at bringing an understanding of a complex issue or object and can extend experience or add strength to what is already known through previous research [www.gslis.utexas.edu, 2012]. Case studies emphasize detailed contextual analysis of a limited number of events or conditions and their relationships.

“The case study approach typically answers research questions that address ‘how and why’ in unexplored research areas and that the results from case studies cannot be subject to statistical generalization or theory-testing, but case studies can be used to generate theoretical constructs, propositions and/or midrange theories.” [Andersen/Skjoett-Larsen, 2009, p. 76].

The second step is that with the help of the case study, certain safeguard mechanisms for compliance matters should be derived. The third step will be the mathematical research:

iv. Is there a perfect contract to incentivize the suppliers to be compliant to the company with the purchase power?

The standard principal – agent model will be introduced and further the derivations of incentive and safeguard mechanisms will be adapted and put into the model. So a

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5 The following structure is based on Andersen/Skjoett-Larsen, 2009
remodeling of the principal – agent model will lead to a new derived expected utility of the principal and a reward system for the agent with regard to CSR and compliance of the CoC.

Three specific companies were chosen: H&M, Inditex Group and Bestseller - all international fashion retailers. They have been elected on the basis of the following criteria [Andersen/Skjoett-Larsen, 2009, p.76]:

- “They have several years of experience of working systematically with CSR in global supply chains [...]”
- They can be considered to be the “social watchdog” – according to their dominant position in the supply chain
- They produce goods for consumers

The fashion retailers fulfill all the criteria due to the fact that they use CSR implemented in their company’s strategy for several years. Further their techniques have shown at least some success in the past and can be taken as role models or benchmarks in the fashion industry. Additionally it can be said, that they all are holding a dominant position in the supply chain and as being a brand – owner, which is indeed the fact for all three companies, they are especially vulnerable to negative publicity [Andersen/Skjoett-Larsen, 2009]. As it will be shown in Chapter 3 reputation is of big importance dealing with CSR.

1.3. Delimitations

The purpose of this section is to point out the main focuses of this thesis. Further it will define the boundaries and limitations.

First limitation was the choice of the topic CSR and further to take the fashion industry in contrast to this subject. Corporate Social Responsibility does not only involve the process of production but the standards under which production is taking place.

Focusing on the principal-agent model, this thesis will only elaborate the relationship between supplier and the purchasing company. The supplier’s CoC is the most common

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6 The structure of Chapter 1.3. is based on Kanchanavipu/Kucukcingoz, 2009
tool to promote global CSR initiatives. In this thesis analyses and discussions are based on the fashion supply chain, since the CSR issues are very prominent. This case study has been carried out by tools and techniques defined in the methodology section which are mainly background research by secondary sources like the Internet [Kanchanavipu/Kucukcingoz, 2009]. Three representatives of the European Fashion Industry are therefore chosen: Bestseller, H&M and Inditex. Those three multi-national enterprises (MNE’s) have a huge supply chain engaging into contracts with suppliers in India, Asia and China.

1.4. Thesis Disposition

This thesis consists of 7 Chapters. Chapter one will discuss the problem this thesis is dealing with. First it describes the introduction with background information, problem discussion, research purpose and finally the delimitations of the study. The second chapter - Important Fundamentals - was developed to present the relevant key facts with respect to Chapter three, which consists of five parts. The first section, named Code of Conduct, describes the basic idea behind the term and further goes into detail with the issues that are targeted in a CoC, specifically in terms of the fashion industry. The second section - Assessing ethical performance - explains how companies can proof how engaged they are in CSR and on what kind of level they are working. Furthermore a sub-section will explain the ISO – Standards. These standards were developed for reporting CSR measures in order to show credibility. The third section is devoted to findings out why CSR came to such big importance – Motivations to engage into CSR. The fourth section – Theories in Supply Chain Management – comprises of the introduction of five theories in supply chain management: the Stakeholder Theory, Transaction cost analysis, Network theory, Incomplete contract theory and finally the main issue this thesis is dealing with, the principal – agent theory will be introduced in detail. The last section 3.5 is called Implementing and Managing Codes of Conduct – Safeguard Mechanisms. Five safeguard mechanisms get introduced in order to mitigate problems of asymmetric information within a Principle-Agent setting.

Further in chapter 4 the safeguard mechanisms will be in tested in a case study on three fashion companies: Bestseller, H&M and Inditex Group. In Chapter 5 a principal – agent model will be introduced. Based on certain characteristics a certain model will be chosen
and further remodeled in Chapter 6, where the safeguards will be included in the model
and hence the optimal CSR – Principal-Agent Model will be introduced. Finally Chapter
7 will conclude all the research and this chapter aims to answer all the questions stated at
the very beginning.
2. IMPORTANT FUNDAMENTALS

This chapter will discuss the concepts of sustainability and CSR, which have an impact on the research. Further a review of literature will be offered and definitions and implications for the deviations of sustainability, SSCM (sustainable supply chain management), CSR and CSR in supply chains will be provided.

2.1. Sustainability

“Following the Rio Summit of 1992\(^7\) the concept of sustainability has been widely promoted […]. as the essential new conceptual framework to assess industrial and social development within business activities […]” [Crane/Matten, 2010, p. 32]. “Since the 1980’s, sustainability has been used more in the sense of human sustainability on planet Earth […]” [http://en.wikipedia.org/wiki/Sustainability, 5\(^{th}\) of March 2014]

The definition of sustainability and sustainable development according to the Brundtland Commission of the United Nations on March 20 in 1987 has evolved: “sustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs.” [World Commission on Environment and Development, 1987]

“This […] concept is only the core idea of an elusive and widely contested concept” [Crane/Matten, 2010, p. 33] and additionally one that has also been subject to an enormous number of different definitions.

In the past sustainability was primarily seen as concept to maintain the system, such as the biosphere or the Earth [Crane/Matten, 2010, p.33]. So it only took environmental matters into consideration [Crane/Matten, 2010, p.33].

2.1.1 The triple bottom line


“This extension of the sustainability concept arose primarily because it is not only impractical, but even sometimes impossible, to address the sustainability of the natural environment without also considering the social and economic aspects of relevant communities and their activities.” [Crane/Matten, 2010, p.33]

Thus, the triple bottom line suggests that at the intersection of social, environmental, and economic performance, the concept of sustainability is generated [Carter/Roger, 2008]. This concept includes “activities that organizations can engage in and not only positively affect the natural environment and society, but also result in long-term economic benefit and competitive advantage for the company” [Carter/Roger, 2008, p.365].

![Diagram of the three components of sustainability](image)

Figure 2: The three components of sustainability

“The basic principles of sustainability within the environmental perspective concern the effective management of physical resources so that they are conserved for the future […], while the economic perspective focuses on economic performance of the company itself.” [Crane/Matten, 2010, p. 34/35]. The social perspective target “impacts on business activities on […] communities in less developed countries and regions.” [Crane/Matten, 2010, p. 35].

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8 own representation based on Carter/Rogers (2008)
2.1.2 Supporting facets of the triple bottom line

According to Carter and Rogers (2008) there are four facets of sustainability and the triple bottom line framework that should not be neglected:

\textit{i) Risk Management}

Supply chain risk management is defined as “the ability of a company to manage and further understand its economic, environmental, and social risks within the supply chain.” [Carter/Rogers, 2008, p. 366]. So according to Shrivastava (1995b) a company has to keep its focus beyond the short-term financial results and has to look into the future and create a long-term strategy [Carter/Rogers, 2008].

\textit{ii) Transparency}

This includes that companies show what they are doing in means of social and environmental activities. Transparency not only requires reporting (Chapter 3.2.3), it further involves stakeholders actively in their supply chain processes [Carter/Rogers, 2008].

\textit{iii) Strategy and Culture}

Sustainability approaches of a company and the firm’s strategy should go hand in hand and must be closely interwoven [Carter/Rogers, 2008]. Sustainability should be integrated in the strategy rather than a separate program [Carter/Rogers, 2008].

2.2. Supply Chain Management and Sustainability

The term supply chain management has been defined in the literature as [Carter/Rogers, 2008, p. 368]:

“the integration of key business processes from end-user through original suppliers, that provide products, services and information that add value for customers and other stakeholders” [Lambert et al., 2006, p.2] as well as “the systematic, strategic coordination of the traditional business functions and the tactics across the business functions within a particular company and across businesses with the supply chain, for the purposes of improving the long-term performance of the individual companies, and the supply chain as a whole” [Mentzer et al., 2002, p. 18].
Combine the definition of Supply Chain Management with the aforementioned explanation over the term sustainability; the framework of Sustainable Supply Chain Management (SSCM) can be derived.

SSCM is therefore defined as

“the strategic, transparent integration and achievement of an organization’s social, environmental, and economic goal in the systemic coordination of key inter-organizational business processes for improving the long-term economic performance of the individual company and its supply chains” [Carter/Rogers, 2008, p. 368]

According to Figure 3 to the best strategy for a company is to embed all measures of environmental, social and economic factors in their strategy [Carter/Rogers, 2008]. To only look at social and environmental performance would neglect economic performance, because according to Walley and Whitehead (1994) compliance with reactive governmental regulations can result in higher cost for business.

“Until recently, both theory and practice within SCM have focused on issues such as integration of processes across supply chain partners, cost-efficiency of supply chains, and customer service. However, with the increased outsourcing of activities to developing

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Figure 3: Sustainable Supply Chain Management

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9 own representation based on Carter/Rogers (2008), p. 369
countries and low-cost countries in Central and Eastern Europe as well as India and Asia, growing concerns about social and environmental impacts of production and consumption have led to a renewed interest in issues related to reverse logistics, environmental management, green and sustainable supply chains” [Andersen/ Skjoett-Larsen, 2009, p. 76].

“Most logistics and supply chain management research has examined issues such as the environment, safety, and human rights in a stand-alone fashion, without consideration of potential interrelationships among these and other aspects of social responsibility.” [Carter/Rogers, 2008, p. 360]

2.3. Corporate Social Responsibility

“Corporate social responsibility (CSR) is a broader concept and not limited to supply chains, but to the company’s overall treatment of human beings and the environment.” [Andersen/Skjoett-Larsen, 2009, p. 77]

“CSR reflects the organizations considerations on the interests of society by simply assuming responsibility themselves for the impact of their activities on customers, suppliers, employees, shareholders, communities, stakeholders, as well as the environment [Grayson/Hodges, 2004]. It can be regarded as companies’ efforts beyond their legal obligations whereby they take further steps to improve the quality of life for employees and their families as well as for the local community and society at large. At the same time, CSR is becoming more critical in the development of the corporate strategies for the companies. Although CSR is a well-established concept, it is hard to find a consensus on the meaning of CSR in practice CSR is not a new phenomenon. There is extensive literature built about the importance of CSR to MNCs business, society and environment.” [Kanchanavipu/Kucukcingoz, 2009, p.1]

The CSR definition has different interpretations according to different organizations and companies. In another definition CSR is termed as “corporate activity and its impact on different social groups,” [Sethi, 1995]. The European Commission defines CRS as “a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with stakeholders on a voluntary basis” [European Commission, 2001].
“Carroll (1979) developed a CSR pyramid presented in Figure [4] where the business priorities are categorized according to their importance in sustainability of companies’ businesses.” [Kanchanavipu/Kucukcingoz, 2009, p.2]

“The first layer in the pyramid is economic responsibility. This basically signifies producing goods and services that society wants. This is the basic and the most important part of company responsibility since the profit comes from economic activities. The second layer represents the legal obligations that need to be fulfilled during economic activities of the companies. Ethical responsibility refers the society’s expectations of business beyond legal requirements. The final layer is named discretionary responsibilities representing philanthropic and social initiatives of the company.” [Kanchanavipu/Kucukcingoz, 2009, p.2]

![Diagram of Carroll's CSR pyramid]

“As shown by the CSR pyramid, social initiatives and the company’s responsibility towards the environment and the society are discretionary actions, which are not rigid obligations. However recently with the increasing public awareness, many companies are realizing that this final layer is now actually among the most debated phenomena in business sustainability. Many governments are extending regulation and mandates in

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10 own representation based on Crane/Matten, 2010
social responsibility reporting.” [Kanchanavipu/Kucukcingoz, 2009, p. 2-3] As the definition given by the European Commission states, engaging into CSR is a voluntary matter. Literature argues the advantages or disadvantages of non-regulation and no consistent emerges whether regulation has a positive or negative impact on companies [Williamson et al, 2006].

2.4. Corporate Social Responsibility in global supply chains

“CSR in no longer the individual company’s domain it also gets an issue of the entire supply chain.” [Andersen/Skjoett-Larsen, 2009, p. 77]

A company has to encompass its vision over the whole supply chain network [Lummus/Vokurka, 1999]. They are also held responsible for environmental and labor practices of their global trading partners such as suppliers, third party logistics providers, and intermediaries over which they have no ownership [Andersen/Skjoett-Larsen, 2009]. To maintain pressure and expectations, many MNCs have reacted by implementing systems and procedures to ensure that their suppliers comply with social and environmental standards [Andersen/Skjoett-Larsen, 2009]. The most have chosen approach to systemize CSR efforts in supply chains is the implementation of Code of Conducts [Andersen/Skjoett-Larsen, 2009].
3. THEORETICAL FRAMEWORK

This chapter will describe the complementary theories to supply chain management. Those theories have an impact on the research conducted in this thesis. After introducing the basic essential for proper CRS implementation in a company and reasons for motivations in engaging in CSR, an analysis of the literature will highlight four theoretical foundations based on different notions of socio-economic theories trying to explain inter-organizational phenomena [Halldorsson et al., 2007].

This section and the following literature review and the assessment of the theories have been performed in five parts. The first section named Codes of Conduct describes the basic idea behind the term and further goes into detail with the issues that are targeted in a CoC especially in terms of the fashion industry. The next section – Assessing ethical performance – explains how companies can proof how engaged they are in CSR and on what kind of level they are working. Further a sub-section will explain the ISO – Standard, that are standards developed for reporting issues to show credibility. The fourth section is devoted to why CSR came to such big importance – Motivations to engage into CSR. The fourth section – Theoretical Background – comprises of five theories that have a huge impact. The last section is called Implementing and Managing Codes of Conduct – Safeguard Mechanism. This section is of high importance for the following chapters because the Case Study that shows how three individual companies are making use of them is based on this section. Those mechanisms are implemented to assure compliance within the supply chain and the contract partners.

3.1. Code of Conduct

As stated in Chapter 2, the most visible element to systematize CSR effort in supply chains is the implementation of CoC.

“In an increasingly globalized world companies are making a higher effort to implement CSR strategies in their supply chains. Consumers, the media and international watchdogs are enhancing the pressure on companies to focus on topics like working conditions, the abuse of union rights, child labor or pollution. This is especially true for companies producing within global supply chains and utilizing strategic comparative advantage by
producing in developing countries [www.ide.go.jp, 2012]. Many multinational corporations responded to the pressure by introducing certain requirements, codes of conducts that intend to increase the social and environmental performance of the company [Pedersen/Andersen, 2006].” [Bachmann/Ivansits, 2011]

“Codes of ethics or codes of conducts are voluntary statements that commit organizations, industries, or professions to specific beliefs, values, and actions and/or that set out appropriate ethical behavior for employees” [Crane/Matten, 2010]

“The branded clothing sector already has a wide adoption of codes of conducts and shows a good performer in the implementation of CSR Strategies [Roberts, 2003]. Codes of conduct describe specific standards and requirements, which have to be fulfilled by cooperating companies in order to be accepted as a supplier. Most CoC describe, in detail, the companies ethics and standards. The guidelines written down in this statement aim that all participants in the supply chain, including subcontractors, are compliant to these standards stated in the code of conduct.

A code of conduct can include specific points such as Human Rights and Labor Rights such as Health and Safety which provides protection from chemical exposure, fire safety, Environmental Protection that would encompass chemical restrictions and water standards and Animal Welfare that is against animal testing and the gain of leather or feather on living animals.

A code of conduct is a voluntary statement of a company, consisting of internal guidelines, standard principles to improve their sustainability [www.oecd.org, 2012]. Since there is no national law to force companies to act responsibly, the code of conduct is not enforceable. So the company is responsible for the compliance of the code of conduct in means of their own company and the other participants in the supply chain. This underlines the importance of safeguarding and monitoring mechanisms, which will be discussed in Chapter 3.5.” [Bachmann/Ivansits, 2011]

3.1.1 Issues – Fashion Industry

The previous chapters have argued the important fundamentals of CSR. Due to high numbers of participants in the supply chain, it is difficult to observe compliance of social and environmental issues. Further this chapter will analyze what issues have to be targeted in a CoC especially in the fashion industry.
i) Social Issues

One of the social issues is the excessive overtime. This is a common problem in many garment-producing countries, especially in China where non-compliance has always been a top issue [www.itradegood.com, 2012]. Working eight hours a day is normal for most within the EC but is seldom seen in China where working fifteen hours daily for up to two weeks or more can be the standard [Punekar/Varickayil, 1990]. Further underpayment and low salary keeps being a big social issue. Especially looking at the case of outsourcing production to countries, where cheap labor is provided.

The upside of sustainability initiatives is that CoC put pressure on the countries governments, which in some cases may lead to rising wages. Especially in Asia and India the number of child labor is still enormous.

ii) Health - and Safety - Issues

Some of the major problems targeting safety and health in the textile industry are health risks due to: the use of pesticides and chemicals and their storage; fire safety and evacuation routes; ergonomic facilities; temperature, noise and dust (including cotton dust) [Van Yperen, 2006, www.fibre2fashion.com, 2012].

iii) Environmental Issues

It is important for firms to consider their human footprint on the global environment, as they are largely responsible for environmental destruction. Resource usage, waste production and environmental degradation caused by human activity are warming the planet and will have abrupt and irreversible consequences [Rosa/Dietz, 2010]. Corporate environmental responsibility is defined as the duty to cover the environmental implications of the company’s operations. This includes how it conducts production and the ability to recycle materials and energy, thusly targeting the elimination of waste and emissions [Mazurkiewicz, 2005].

3.2. Assessing ethical performance

The effective Management of CSR within a firm as well the supply chain relies to some extent on being able to assess and evaluate performance [Crane/Matten, 2010].
According literature, several initiatives for evaluation are in existence, but it can be argued about their outcome [Crane/Matten, 2010].

This chapter discusses the following initiatives: (3.2.1) Social Accounting, (3.2.2) Social Auditing, (3.2.3) Sustainable Reporting and (3.2.4) Norms and ISO-Standards.

3.2.1 Social Accounting

“Organizations are [...] no longer only accountable to shareholders in respect of sustaining available financial return on their capital investment.” [Ackers, 2011, p.10] They are increasingly expected to act responsibly towards, and be accountable to their broader constituencies. From the perspective of the social and environmental impact of their operations, organizational constituencies include owners, financiers, employees, customers (both existing and prospective), suppliers, government and society at large [ACCA, 2007].

“Social accounting is the voluntary process concerned with assessing and communicating organizational activities and impacts on social, ethical, and environmental issues relevant to stakeholders.” [Crane/Matten, 2010, p. 212]

3.2.2 Social Auditing

“A Corporate Social Responsibility audit aims at identifying environmental, social or governance risks faced by the organization and evaluating managerial performance in respect of those.” [www.schematt.com, 2012]

To affirm compliance of the implemented CSR guidelines within the company, supply chain auditing/monitoring are of essential importance. Auditing can either be internal or if external (third party auditing), carried out by specialized groups, mostly NGOs, that have a certain expertise in that field of industry. “At best an audit can only take a snapshot of what is happening within a supplier but often does not explore why it is happening or how the situation can be improved. Without effective follow up, engagement audits alone are unlikely to be effective.” [Spence/Bourlakis, 2009, p. 293-294] The risks of not paying adequate attention to CSR are clear - reputation damage, lawsuits, and government scrutiny. By implementing CSR in the company, some form of CSR auditing is typically embedded as part of the implementation process [Boyd/Spekman/Kamauff/Werhane, 2007].
3.2.3 Sustainable Reporting

An element of responsibility assurance involves actually “assuring” the public that what is claimed in their CoC is what is actually being done [Waddock, 2008]. So it has come that social reporting has established itself as a key element in the movement for making corporations more socially responsible. A certain initiative – The Global Reporting Initiative – gives the guidelines for proper reporting and what is necessary for producing such a report. When a company engages in CSR measures, what prevents them from not telling its stakeholder about the initiatives? Showing what actions the firm is engaging to be sustainable and to prevent conflicts in social and environmental is important information.

“[But in fact], […] reporting can work against the attainment of sustainable development, by hampering the implementation of other mechanisms that would be more effective, such as stricter regulation. That is, if not implemented appropriately, self-regulation through social reporting can allow corporations to effectively escape stricter regulation […]” [Hess, 2008, p.4]

So David Hess developed the “New Governance” regulatory approach, stating that certain three pillars are necessary for reporting to achieve the goal of improving social performance: (i) Disclosure, (ii) Dialogue, and (iii) Development [Hess, 2008].

i) Disclosure

Disclosure requires that the company hands all social and environmental relevant information as well as information based on their actual performance to its stakeholders [Hess, 2008].

ii) Dialogue

Dialogue with stakeholders is a very important measure. “The goal is not simply to have different stakeholders represent their interests in an adversarial forum where each seeks to ‘win’, but rather to have stakeholders engaging in problem-solving and consensus building.” [Hess, 2008, p.27-28]

iii) Development

“The ultimate goal of social reporting is, of course, to actually change corporate behavior in furtherance of the goal of sustainable economic development. This can occur through
external pressures forcing the corporation to change, but it can also occur through a corporation’s own self-critical reflection on its behavior.” [Hess, 2008, p. 30]

3.2.4 Norms and ISO-Standards

To assure that a company is actually involved in CSR and sustainability practices and not only claiming what is being done, the trend emerged of issuing reports with independent verification [Hohnen, 2007]. Therefore NGOs started to verify, monitor and certify companies. Before reports were given to public, which were issued within the company and therefore biased and not really credible. Globally a number of standards have been developed in order to help companies address various aspects of CSR. Most codes of conduct and social standards are established during conventions, such as international workplace norms outlined in the ILO conventions and the Universal Declaration of Human Rights and the Convention on Rights of the Child [Sturm/Müller/Panapanaan, 2000].

Three types of standards and guidelines can be distinguished: standards for CSR performance for the evaluation of compliance; guidelines for the procedure and practices of CSR audit that could be used by auditors to regulate audit behaviors and increase audit quality; or standard and guideline for CSR reporting that could be used by auditors to determine audit scope and audit depth [Iamandi/Filip, 2008]. Those three guidelines can help to increase the performance of CSR auditing and further enhance the quality of CSR performance and reporting within a company.

3.2.5 Norms and Iso-Standards - Overview

This section gives a brief overlook over the most often used guidelines for certification of CSR practices in a company.

3.2.5.1 Global Reporting Initiative

“The Global Reporting Initiative (GRI) is a NGO that promotes economic, environmental and social sustainability.” [https://www.globalreporting.org/, 3th of March 2014]

This initiative provides all companies and organizations with a comprehensive sustainability reporting framework, aiming to help companies, governmental organizations or non-governmental organizations to describe their CSR performance and further give stakeholders a guideline to understand the report [Fadur et al, 2013, p. 14].
3.2.5.2 Global Compact

“The Global Compact (GC), started by the United Nations in 2000, is a strategic policy initiative for businesses that are committed to aligning their operations and strategies with ten universally accepted principles in the areas of human rights, labor, environment and anti-corruption.” [www.unglobalcompact.org, 3rd of March 2014]

Unlike some other UN treaties, the participants of GC are companies rather than countries. After being a participant of GC, a company is required to report and suggested to use the index system of GRI [www.unglobalcompact.org].

3.2.5.3 Social Accountability 8000\textsuperscript{11}

Social Accountability (SA) 8000 is a designation certifying a company’s performance in nine essential areas: child labor, forced labor, health and safety, freedom of association, discrimination, disciplinary practices, working hours, remuneration, and management systems. To receive a certification conform SA8000, auditing is necessary. Auditors will visit factories and assess corporate practice on a wide range of issues and evaluate the state of a company’s management systems, necessary to ensure ongoing acceptable practices. In case of full compliance with the SA 8000 conformity, a company can earn a certificate. This certification provides a public report of good practice to consumers, buyers, and other companies. It is intended to be a significant milestone in improving workplace conditions. Once a certification is done, further auditing in certain range has to be done because it is an ongoing process.

3.2.5.4 BSCI\textsuperscript{12}

The BSCI (Business Social Compliance Initiative) monitoring system offers a common CSR approach for European retailers, importers, and manufacturers. The initiative's goal is to continuously improve the social performance of suppliers, leading to best practices

\textsuperscript{11} The following section is a direct quote of the source: www.sa-intl.org, 2012, access 26\textsuperscript{th} of December 2012, 15:54

\textsuperscript{12} The following section is a direct quote of the source: www.bsci-intl.org, access 26\textsuperscript{th} of December 2012, 16:15
(such as SA8000 certification or equivalent) and sustainably enhancing working conditions in factories worldwide. To participate in BSCI, companies and associations are required to first become member of the Foreign Trade Association\textsuperscript{13}.

3.2.5.5 \textit{WRAP}\textsuperscript{14}

“The WRAP certification program provides guidelines for workplace conditions at sewn product manufacturing facilities. The program's objective is to independently monitor and certify compliance with socially responsible global standards for manufacturing, and ensure that the manufactured products are produced under lawful, humane and ethical conditions” [www.intertek-sc.com, 26\textsuperscript{th} of December 2012].

3.2.5.6 \textit{ISO 26000}\textsuperscript{15}

The ISO 26000 is a guideline for standards developed by the International Organization for Standardization (ISO) and it aims to assist organizations in contributing to sustainable development. The standards are used to encourage companies to go beyond legal compliance, recognizing that compliance with law is a fundamental duty of any organization and an essential part of their social responsibility. It is intended to promote common understanding in the field of social responsibility, and to complement other instruments and initiatives for social responsibility, not to replace them. ISO has a membership of 163 national standards bodies from countries large and small, industrialized, developing and in transition, in all regions of the world. ISO-standards provide solutions and achieve benefits for almost all sectors of activity, including agriculture, construction, mechanical engineering, manufacturing, distribution, transport,

\textsuperscript{13} \textit{Foreign Trade Association (FTA)}: The FTA is the association of European and International commerce that promotes the values of free and sustainable trade. It brings together hundreds of retailers, importers, brand companies, and national associations to improve the political and legal framework for trade [www.fta-eu.org/, 2012].

\textsuperscript{14} The following section is a direct quote of the source: www.intertek-sc.com, 26\textsuperscript{th} of December 2012, 13:02

\textsuperscript{15} The following section is a direct quote of the source: www.iso.org, access 26th of December 2012, 16:52
medical devices, information and communication technologies, the environment, energy, quality management, conformity assessment and services.

3.3. **Motivations to engage into CSR**

In the 1970s Milton Friedman wrote the article "The Social Responsibility of Business Is To Increase Its Profits", where he stated that CSR is dangerous as it constrains profit opportunities [Friedman, 1970].

Friedman’s argument provoked economists to explore the conditions under which CSR can be economically justified and therefore the number researches done in the past multiplied [Hernández-Murillo/ Martinek, 2004].

While comparing marketplaces, a lot has changed since the 1970’s. “The web sites of more than 80% of the Fortune 500 address CSR issues, reflecting the belief among business leaders that engaging in CSR is not only and ethical or ideological matter, but also an economic one.” [Mittal, 2008, p. 24] An increasing number of scientific studies show clear and identifiable benefits when companies implement CSR measures [Van Yperen, 2006]. Hence, according to research it can be derived that manager “very well understand that CSR can promote higher reputation and respect for their company amongst their shareholders which can result in higher sales, enhance employee loyalty and attract better personnel to the firm” [Robins, 2011] Further, “CSR activities focusing on sustainability issues may lower costs and improve efficiencies as well.” [Robins, 2011] A further advantage, especially for public corporations implementing CSR strategies, is a possible listing in the FTSE4Good or Dow Jones Sustainability Indexes, or other similar indices [Robins, 2011]. “More than 100 empirical studies published between 1972 and 2000 have examined the relationship between companies’ socially responsible conduct and financial performance” [Van Yperen, 2006]

Nevertheless businesses should strive to maintain a balance between their corporate social responsibility and profit maximization [www.tkf.org.in, 2011]. If they are able to strike the right balance, then both the society and the organization stand to benefit from it. Society contributes in many ways towards the survival and growth of an organization [www.tkf.org.in, 2011]. So, some amount of profit acquired at the end of the financial
year should go towards the welfare of the society [www.tkf.org.in, 2011]. “Generally stated, CSR leads to a more beneficial situation in terms of cost savings through improved working conditions, higher loyalty and productivity by workers, saved costs by energy efficiency and cleaner production and better opportunities for international trade and attracting foreign clients and financiers” [Van Yperen, 2006, p.5]. Thus, it can be concluded that CSR can serve companies in gaining a competitive advantage, if measures are integrated properly into the business operations, monitored and communicated to stakeholders and society at large. However the firm needs to adapt a CSR strategy that is aligned with the firms’ strategy and economic objectives.

3.4. Theoretical Background

In 1996 Lamming introduced the theory of Supply Chain Management (SCM) as an extension of logistics, referring to the relationship issues to be considered in the theory of SCM [Lamming, 1996]. Further literature has discussed the issue of inter-organizational management and the following theories will be discussed briefly:

i. Stakeholder theory
ii. Transaction cost analysis
iii. Network theory
iv. Incomplete Contract theory
v. The principal-agent theory

3.4.1 Stakeholder Theory & CSR

A stakeholder is: “Any group or individual who can affect or is affected by the achievement of the organization’s objectives. In return, those individuals and entities also could affect the corporate activities, strategies, policies, operations and targets.” — this is the most traditional definition of a stakeholder by Freeman in 1984.

This theory is generated in the context of increasing conflicts among different corporate stakeholders. Since its emergence, it has been widely accepted, and especially favored by the management levels in corporate.

Hummels (1998) states in his article that the stakeholder theory can be seen as:
"...a managerial theory about the groups and individuals that have a stake in the survival of the company. In order to survive all (f)actors (sic!) who have influence on the continuity of the organization must be managed." [Hummels, 1998, p.1404]

In the traditional view of the firm, the organization does everything to satisfy the shareholders neglecting the fact that other parties are of great importance too. So in principle the stakeholder theory aims to satisfy all needs of internal and external stakeholders due to the influence on the business performance both individually and collectively [Karim, et al., 2007]. Companies need to show returns to its shareholders, meet obligations to debt holders, banks, and others [Freeman, 2006]. “In reality organizations are bound to prioritize demands of their stakeholders’ as it is prohibitively costly to satisfy all stakeholders demands [...]” [Kanchanavipu/Kucukcingoz, 2009, p. 10]

![Figure 5: Corporate Stakeholders](image)

Stakeholder theory also provides a theoretical support to the study of CSR audit. Some essential problems such as audit scope, audit object and quantification of CSR audit, are to some extent solved in this context. The stakeholder theory assists to transform the abstract CSR issue to the concrete stakeholder issue, define the concrete auditing object and build a road from the abstract CSR audit theory to practices.

16 own representation based on Dowling, 2001
3.4.2 Transaction cost analysis

According to Williamson who invented the transaction cost analysis, he assumes that a company may reduce its total transaction costs by cooperating with external partners. Further it is claimed that economical institutions are only used for reduction of transaction costs [Williamson, 1975, 1985, 1996]. Coase proposed that under certain conditions, the costs of conducting economic exchange in a market may exceed the costs of organizing the exchange within a firm. In this context, transaction costs are the "costs of running the system" and include such ex ante costs as drafting and negotiating contracts and such ex post costs as monitoring and enforcing agreements [Thechatakerng, 2003, p.68].

Halldorsson suggests that with engaging in long – term relationships/cooperation with only a few suppliers, transaction costs will decrease. But those bear the risk of opportunistic behavior. Therefore it might be necessary to include “safeguards” in the contracts [Halldorsson et al, 2007].

3.4.3 Network Theory

"The performance of a firm does not only depend on how efficiently the company cooperates with its direct partners, but also how they cooperate with their own business partner", first-/second tier partners [Halldorsson et al, 2007, p. 287]. Acting together with all stakeholders leads to a big advantage but involves a lot of trust. Trust between the parties as a condition for gaining the best possible results from cooperation [Halldorsson et al, 2007]. “Thus, firms with efficient, cooperative arrangements might gain competitive advantage over firms that have to bear transaction costs to prevent their transport firms from action in an opportunistic environment.” [Halldorsson et al, 2007, p. 289]

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17 Transaction costs: The cost associated with exchange of goods or services and incurred in overcoming market imperfections. Transaction costs cover a wide range: communication charges, legal fees, informational cost of finding the price, quality, and durability, etc., and may also include transportation costs. Transaction costs are a critical factor in deciding whether to make a product or buy it. They are called frictional cost as well [businessdictionary.com].
3.4.4 *Incomplete Contract Theory*

According to Coase, Williamson and Klein, Crawford and Alchian transaction costs go hand in hand with contracting [Hart, 1993]. Two assumptions are postulated for the Incomplete Contract Theory (ICT): firstly some investments are not contractible; secondly “parties to a contract cannot prevent themselves from renegotiating the terms if it is mutually beneficial to do so” [Lyons, 2001, p. 2]. In particular, a contract cannot condition prices (or anything else) on ex post investments [Lyons, 2001]. According to Lyons (2001) both parties use the contract in the context of an effective legal system to frame these renegotiations. Furthermore, as implied in “the name, incomplete contract theory suggests that the theory’s main concern is to consider the limitations of contracts that fail to specify not only investment levels, but also many of the other contingencies that a complete contract might wish to include.” [Lyons, 2001, p. 1]

3.4.5 *Principle Agent Theory*

"Whenever one individual depends on the action of another, an agency relationship arises. The individual taking the action is called the agent. The affected party is the principal."
[Pratt/Zechhauser, 1985, p.2]

Every company is based on the economic fundamentals of division of work and cooperation [Smith, 1776]. Both fundamental enable the specialization of each individual and therefore assess the cost reduction and improvement in performance necessary for financial success of a corporation [Jost, 2001]. The easiest way to reflect a bilateral cooperation is the Principal Agent Model [Jost, 2001]. Business Economics Principal – Agent problems are mostly discussed in context of Management problems [Elschen, 1991; Mensch, 1999]. Based on the separation of ownership and control of economic activities between the agent and principal, various agency problems may arise, such as asymmetric information between the principal and the agent, conflicting objectives, difference in risk aversion, outcome uncertainty, behavior based on self-interest, and bounded rationality [Halldorsen et al, 2007]. “The principal-agent relationship arises when one party (the principal) hires another party (the agent) to perform some service and then delegate decision-making authority to the agents." [Germanova, 2008, p. 9]. So the delegation of work and tasks to others has become crucial. In order to fulfill the proper execution of the task incentives are a good measure.
Delegation of a task to an agent who has different objectives than the principal is problematic when information about the agent is imperfect. This is the essence of incentive questions.

An economic agency theory goal is to find the optimal contract for each party. A contract is a reliable promise by both parties, in which the obligations of each, for all possible contingencies, are specified [Macho-Stadler/Pérez-Castrillo, 1997]. First of all, for future success of cooperation, is the determination of the rules based on the relationship: How to perform the delegated tasks? How to separate profit and wage? How to assure compliance? [Jost, 2011] Both act in their own interests and an alignment has to be found of both interest’s.

3.4.5.1 Principal-Agent-Relationship – Information Asymmetry

In case of symmetric information, the establishment of a contract with the right incentive scheme would be easy to develop because the principal has full information over the depended factors based on the remuneration of the agent. But in reality the principal will never have full information. So the problem in the Principal-Agent-Theory is to find the right incentive scheme based on each individual supplier due to asymmetric information. In Principal-Agent-Relationships it can be distinguished, two forms of information asymmetry. Each form is characterized through different information advantages on the

\[18\] own representation, based on Picot, 2001
agent’s side which goes hand in hand with a specific form of behavior uncertainty, i.e. either the agent or the principal are better informed than the other [Mensch, 1999].

The basis of the principal-agent relationship is the information asymmetry. In the unrealistic case of perfect information, the problems explained in Table 2 would not occur since the advantage of additional information is not given. Therefore the so-called first-best solution would be realized. But in a world without perfect information, it is cost-intensive to get the right information, therefore the second-best solution can be realized, due to the fact that the agent can easily make decisions which are opportunistic [Pratt/Zeckhauser, 1991]. So the principal-agent problem aims to formulate a contract, which follows the Pareto-Optimum19 [Kaluza/Dullnig/Malle, 2003]. In that case it is impossible to favor one contract partner, so both involved in the contract are equal on terms [Sälter, 1989]. Therefore according to the pareto-optimal solution based contract, additional costs incur so-called agency costs.

According to Jensen and Meckling (1976), agency costs can be categorized into three kinds of costs:

- bonding costs (the costs to earn the principals trust and signaling costs)
- monitoring costs (costs that occur for the focal enterprise in order to motivate the agent to be exert a pre-established action)
- residual loss (resulting from pareto efficiency)

Those costs equal the difference of the first-best solution with full information and the second-best solution with asymmetric information (Moral Hazard, Adverse Selection) [Spreemann, 1988].

Further two assumptions are discussed in literature: either the agent is risk-neutral (= principal is risk-averse), but lacks the financial resources to purchase the revenue out of cooperation, or the agent is risk-averse (= principal is risk-neutral) and due to the purchase and the increased risk, additional costs occur [Jost, 2001].

19 In a pareto efficient economic allocation, no one can be made better off without making at least one individual worse off [Osborne/Rubenstein, 1994].
The first assumption claims that it is not possible for the agent to receive full remuneration even though there is failure involved [Jost, 2001]. Typical example is the relationship between an employer and his employee who happens to get a fix wage every month.

The second assumption discussed the fact that the principal is risk-neutral and therefore stresses that the principal faces all the risk and offers the agent a compensation scheme that guarantees the agent a constant remuneration [Jost, 2001]. But on the other side, offering the agent a fixed wage, leads to incentive problems. With a continuous remuneration the effort level, that is not observable, has no impact on the final fix wage. The question is now, how to ensure the exertion of a high effort level.

Taking the principals perspective, a way to answer the above stated question is, that the principal “rents” the delegated task to the agent and therefore transfers all the risk to the agent [Jost, 2001]. In that case the incentive for fulfilling the work, as determined in the contract, is given, but of course the principal has to pay the agent a certain risk premium and therefore is confronted with higher costs [Jost, 2001]. Hence, this solution seems suboptimal too.

3.4.5.2 Incentive problems

Figure 9 highlights the timing when a principal wants/is delegating a task to an agent [Laffont/Martimort, 2006].

![Figure 7: Timing in a Principal-Agents setting with symmetric information](image)

\[ \text{Figure 7: Timing in a Principal-Agents setting with symmetric information}^{20} \]

\[^{20}\text{own representation based on Jost, 2001, p. 24}\]
At \( t_1 \) the principal offers the agent a contract and at \( t_2 \) the agent decides whether the contract is accepted or not. After accepting the offer, the agent either chooses to exert high effort or low effort and in \( t_4 \) he will receive the wage.

In a world with symmetric information this whole process is observable. But since there is an information asymmetry, the behavior is not observable and viable and therefore incentive problems occur.

In literature it can be distinguished between the following incentive problems:

- **Moral Hazard**: “This problem occurs, when the *ex post* behavior of the agent is not appropriate, i.e. the agent with more information about its actions has an incentive to behave not in line with the principals’ interest.” [Ciliberti et al., 2011] So when an agent gets a task delegated by a principal, he may choose actions, which affect the value of trade or, more generally, the agent's performance [Laffont/Martimort, 2006]. By the mere fact of delegation, the principal loses any ability to control those actions when those actions are no longer observable by the principal who offers the contract [Laffont/Martimort, 2006].

- **Hidden characteristics** describe the situation *ex ante* engaging into a contract, where the principal has no knowledge of the agent’s features necessary for attaining the target, such as risk attitude, talent, and diligence [Picot/Neuburger, 1995]. Typically

\[ \text{Figure 8: Principal-Agent Timing in a Moral Hazard setting}^{21} \]

Under certain circumstances it is possible that the principal gains information before the finalization of the task [Jost, 2001], with for e.g. monitoring.

21 own representation based on Jost, 2001, p. 26
for hidden characteristics is the possibility of pretending wrong information, but the wrong choice reveals ex post [Karmann, 1992; Spremann, 1990]. So adverse selection occurs, where ex ante information exchange is not appropriate, i.e. the principal is not informed about a certain characteristic of the agent [Baumgartner, 2011], his type $\theta$.

![Figure 9: Timing in Principal Agent – Model

Table 1 summarizes the characteristics of the distinction criteria in principal – agent problems. Further it gives directions how to cope with the certain situations.

<table>
<thead>
<tr>
<th>Distinction criteria</th>
<th>Hidden characteristics</th>
<th>Hidden action/Hidden information</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal is uninformed about:</td>
<td>Quality properties of the agent’s effort</td>
<td>Efforts of agents are unobservable/not valuable</td>
</tr>
<tr>
<td>Root of problem:</td>
<td>Hidden properties or claimed features of the agent</td>
<td>Monitoring/Auditing and costs that occur due to monitoring</td>
</tr>
<tr>
<td>The agent’s behavior range:</td>
<td>ex ante</td>
<td>ex post</td>
</tr>
<tr>
<td>PROBLEM</td>
<td>Adverse Selection</td>
<td>Moral Hazard</td>
</tr>
<tr>
<td>Measure to cope with the problem:</td>
<td>Elimination of information asymmetry with a. Signaling, Screening b. Self selection ii. Alignment of interests</td>
<td>Alignment of interest i. Reduction of information asymmetry (Monitoring)</td>
</tr>
<tr>
<td>Measurements:</td>
<td>ad i) certification/balances ad ii) differentiation of cooperation contracts ad ii) Reputation of contract partner</td>
<td>ad i) profit sharing (bonus or share of company ad ii) with help of third party auditing, internal auditing, reporting</td>
</tr>
</tbody>
</table>

Table 1: Distinction criteria Principal-Agent Problem

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22. Laffont/Martimort, 2006

23. own representation based on Picot, 2001
Measures to cope with the problem of Adverse Selection and Moral Hazard are signaling, screening, monitoring and auditing. Control – Mechanisms such as monitoring and auditing are supposed to be very cost-effective [Neus, 1989], to align the interest and keep the costs down. In that case the contract would be optimal for both, the principal and the agent and the rational behavior of the agent would evolve to the principal’s advantage.

As monitoring and auditing is playing a huge part in CSR and especially in the focus of the CSR-strategies of Bestseller, H&M and Inditex Group are investing a lot of money in those measures.

The less cost-effective measures for interest alignment according to literature is divided in two approaches:

- **Screening**: the principal aims to reveal more information about the agent. This presupposes that one market participant holds private information that for some reason cannot be verifiably disclosed, and which affects the other participant’s incentives [Hörner, 2006]. In context of the principal – agent theory literature talks about the screening – game. This game is a form of self-selection, in which the principal is making use of the opportunistic behavior of the agent to receive more information about the agent and his abilities. In the game the principal offers the agent different contracts alternatives (e.g. fix or variable remuneration). Based on the choice of contract the principal can derive the willingness to perform.

- **Signaling**: the agent is having the initiative. The agent is offering the principal ex-ante information. Most literature example is the curriculum vitae of a prospective employee. According to the education the agent is judged. So higher education might signal that the agent is very productive, but here lies the risk. A signal cannot give evidence of the real agent’s status.

3.4.5.3 Principal Agent Problem in the supply chain

In the literature of principal-agent theory, the separation of ownership and control, on firm-intern level, is mostly discussed. But the problem of the principal and agent also occurs within a supply chain. It appears on several levels of the chain, in which various companies are involved in engineering a product and mostly every company once takes
the position of being the principal as well as the agent [Busch, 2000; Hess, 1999], due to
the fact that delegation is involved.

According to Wolters, who analyzed the automobile industry and their relationship with
suppliers, abuse of convenience is a grave issue in networks and supply chains [Wolters,
1995]. The outcome of the analysis is that those abuses retrieve from trust issues and
asymmetric information [Wolters, 1995]. For a successful supply chain management it is
really necessary to have a trustworthy relationship [Kaluza/Dullnig/Malle, 2003].
“Whatever the form of inter-firm relationships, the opportunism factor always exists and
consequently business contracts become progressively more complex to overcome
through this basic impulse of business agents.” [Kanchanavipu/Kucukcinoz, 2009, p. 9]

The complexity, the uncertainty, information asymmetry and the state of subjection in
means of transaction can be very problematic for the principal. The resulting coordination
problems can lead to increased transaction costs. Close relationships between customer
and supplier can decrease those costs and therefore the tendency of working with one
supplier for more than one period increases trust and hence the costs of transaction
decrease. Therefore the business relationships are characterized by though risk-decreasing
elements such as commitment, goal congruency and trust.

3.4.5.4 Principal Agent Problem in the supply chain and CSR

“Applications of the agency theory in supply chain management are rather scarce.”
[Ciliberti et al, 2011, p. 886]. This could depend on the fact that the typical principal
agent model is rather used in a one and one – environment, whereas in a supply chain,
there are numerous agents and principals involved [Ciliberti et al, 2011].

“When applying the principal – agent theory to the supply chain context, the
chain director may be considered, as the principal and the other participant in
the supply chains are the agents. Supply chain partners have partly conflicting
goals as they all aim to create more value collectively, but might want to get a
larger part, or want to make less effort in for the same reward as before.”
[Ciliberti et al, 2011, p. 886]

Problem is, that some potential partners may not offer, what they have promised ex-ante
(typical adverse selection problem) and/or may underperform and blame limited output to
external conditions ex-post (i.e. moral hazard).
“In order to address these problems, the chain director needs a monitoring device to learn about the agent’s efforts” [Ciliberti et al, 2011, p. 886] and further use certain safeguard mechanisms to stipulate compliance.

3.5. Implementing and Managing Codes of Conduct – Safeguard Mechanisms

Opportunistic behavior is a major threat in the planning and implementation of CoC in global supply chains [O’Donnell, 2000]. The implementation and the compliance of CoC can be tremendously expensive looking at the fact that a supplier has to implement certain standards according to the ethical guidelines. “So these initiatives can be costly and time consuming. As a consequence, suppliers might have an economic incentive to reduce social and environmental standards in order to achieve financial gains.” [Pedersen/Andersen, 2006, p. 9]. Mostly the benefit of CSR activities is on behalf of the initiating company and not equally distributed as can be seen especially in brand holding companies. It would be easy to deal with this opportunism if it were possible to formulate an enforceable contract, which included all contingencies [Pedersen/Andersen, 2006]. So the question is how to manage and safeguards because mostly it is hard to verify whether a supplier has actually complied with the CoC. Further it is argued about the CoC are “criticised for being weak in operational implementation, haphazard, as well as always too little and too late” [Kanchanivapu/ Kucukcinogoz, 2009, p.12].

“The potential conflict of interest between the companies in the supply chains and the incomplete nature of Codes of Conduct makes it relevant to discuss how an initiator of a code can be ‘safeguarded’ from non-compliance on part of its suppliers.” [Pedersen/Andersen, 2006, p. 231]. To answer this question the existing literature
suggests some measures, which can be grouped into two groups; direct safeguards and indirect safeguard mechanisms.

![Figure 10: Safeguard Mechanisms](image)

3.5.1 Direct Safeguards

Direct Safeguard mechanisms are used directly to give the supplier a direct incentive to be compliant by observation. They can be distinguished in direct sanctions and third party intervention.

- **Direct Sanctions**

Provided that a company has a sufficient level of bargaining power in the supply chain the mechanism of direct sanction seems to be straightforward. In the case of noncompliance of a supplier a company can directly punish them. Direct sanctions might manifest themselves in different forms. The buyer can withhold payments until a certain improvement is undertaken or simply decrease the quantity of orders. The fastest and most ultimate sanction is certainly to break off the relationship with the supplier [Pedersen/Andersen, 2006]. Direct sanctions can be very effective safeguard mechanisms; however the reciprocal character of the buyer-supplier relationship makes this mechanism ineffective. When a company imposes direct sanctions on a supplier it has

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24 own representation based on Pedersen/Andersen, 2006

25 Section 3.5.1 is part of Bachmann/Ivansits 2011
to calculate the indirect costs for the company itself. For instance, the cost of breaking
the long-term relationship with the supplier or the cost of lost investments in e.g.
improving the working conditions of the supplier. When the costs outweigh the benefits
from the long-term cooperation, the direct sanctions are rather unrealistic. Furthermore
the implementation of direct sanction can be difficult since non-compliance with the CoC
is not always visible.

- **Third-party intervention**

The legal system, industry organizations, external auditors, the public and NGO’s are
examples for third parties who can play an important role to safeguard the COC of a
company. The most important institution might be the legal system of the states. If a
supplier is not acting according to the national law, he can be punished and forced to alter
its behavior. However, since the COC often go beyond national law requirements, legal
institutions can assure compliance only to a limited extent. Weak institutional structure
and unclear formulated COC make the enforcement of the codes difficult. Therefore, it is
relevant to consider additional third parties that can safeguard the companies COC.
External auditors for example can help to increase the credibility of a company’s CSR-
strategy. Certification agencies can help to screen the market, reduce the search costs and
assure that a supplier is in compliance with the requirements of a company. The public,
NGO’s and watchdogs can exert considerable pressure on a company and force them to
engage in a sustainable strategy.

### 3.5.2 Indirect Safeguard Mechanisms

Further indirect mechanisms for compliance can align the interests of the supplier with the
ones of the company in means. “Indirect measures comprise elements which could be
regarded as soft values and indirect actions that take place in a longer time period,
however, are seen as more influential.”[Kanchanivapu/Kucukcingoz, 2009, p.13]

Pedersen and Andersen (2006) suggest the three following indirect safeguard
mechanisms: Goal congruence, Reputation Effect and Trust.

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26 Section 3.5.2 is part of Bachmann/Ivansits 2011
• **Goal Congruence**

In order to overcome the principal agent problem, measures to increase goal congruence are crucial to lower the risk of moral hazard. Opportunism is only likely to occur, if there is a conflict of interest between the principal and the agent. It is not enough if the initiating firm has a strong interest in implementing CSR-Strategies; it also has to convince its suppliers, that such a behavior is preferable. Goal congruence is especially important in global supply chains, where non-compliance is often invisible and monitoring is costly. It can be achieved in many different ways. The initiating company can compensate its suppliers for the costs social and environmental enhancing strategies may cause. The buyer can reward the supplier for desired behavior; buyer and supplier can undertake joint investments and the buyer can involve the supplier in the development and integration of the Code of Conduct [Pedersen/Andersen, 2006].

• **Reputation Effect**

An improvement of the external perception and reputation of a company can be a central determinant for why a company is engaging in CSR. Communicating benefits of improved reputation to its suppliers can be an important task for a company in order to safeguard its CSR-Strategies. The supplier should understand that reputation can be seen as a resource to create a strategic advantage and generate higher future income [Roberts/Dowling, 1997; Koch, 1995]. When suppliers are convinced, that the integration of sound CSR-Measures can be rewarding and is in line with their interests, a large part of the conflict of interests between buyer and supplier disappears.

It is important to analyze the power structures in the supply chain relay on reputation as a safeguard mechanism [Pedersen/Andersen, 2006]. First, the brand owner will be the main beneficiary of an improvement in the brand reputation [Roberts, 2003]. A good reputation enhances the value of all products and services a company sells. The question remains, if the brand-owner is able to pass on some of these benefits down the supply chain and convince the suppliers to act as a reliable partner. An upstream concentration of bargaining power will make will make compliance with brand owner requirements more likely. Traditionally, the branded clothing sector has a wide adoption of COC concerning working conditions, labor rights and environmental problems [Roberts, 2003]. Brand-
owners usually face a large number of competing suppliers, willing to produce the goods the brand-owner needs. In such a setting the brand-owner has a good bargaining position to require the implementation of COC in their supply chain. On the other hand, if the brand owner is engaging in long term-relationships, compliance might become the preferable strategy for the suppliers. Higher future benefits of being a reliable partner might outweigh short-term cost-savings through noncompliance. Thus, to relay on reputation effects as a safeguard mechanism, analysis of the distribution of bargaining power in the supply chain is required and a closer look at the relationship between buyers and suppliers has to be conducted.

• **Trust**

Asymmetric information between principal and agent might lead to moral hazard and opportunistic behavior as described above. Engaging in long-term relationships provides both sides with additional information about each other and helps to assess the risk of hidden action more accurately. A long-term relationship can be understood as an ongoing screening process of the contractual partner. When a supplier was behaving in a cooperative and productive manner in the past, the buyer might expect him to follow the same behavior in the future [Pedersen/Andersen, 2006]. Thus, a relationship characterized by trust can emerge between the parties. As a consequence controlling and monitoring effort can be reduced and translate to considerable cost savings for the buyer.
4. CASE STUDY - INTRODUCTION

As described in preceding chapters, to overcome the classical Principal Agent Problem (PAM) during the integration and maintenance of CSR strategies, certain safeguard mechanisms can assure compliance with the CoC throughout the supply chain. According to Koch (1995) and Pedersen/Andersen (2006) it will be distinguished between five different safeguard mechanisms: reputation effects, trust, goal congruence, third party interventions and direct sanctions. These concepts partly overlap and have blurred boundaries. Based on a case study written by Johannes Bachmann and Sarah Ivansits in 2011 at Copenhagen Business School (How BESTSELLER safeguards its global supply chain - an evaluation of BESTSELLER's way of dealing with CSR in their supply chain)\textsuperscript{27}, this chapter will explain how these different safeguard mechanisms are used in practice on example of the three fashion companies: Bestseller, Inditex Group and H&M. It will analyze how the three fashion company's act in means of the five safeguard mechanisms, by analyzing their CoC and supplier guidelines. Furthermore a sixth dimension - transparency, extends the safeguard mechanisms.

4.1. Research Procedure

As highlighted in Figure 11, the case study is performed with the help of an explorative analysis approach.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{explorative_analysis_approach.png}
\caption{Explorative analysis approach\textsuperscript{28}}
\end{figure}

\textsuperscript{27} The project paper „How BESTSELLER safeguards its global supply chain - an evaluation of BESTSELLER's way of dealing with CSR in their supply chain” is displayed in Chapter 10.4.

\textsuperscript{28} own representation
First Step: Choice of Company

As described in Chapter 1 the choice of Bestseller, Inditex Group was based on the following characteristic:

- They have several years of experience of working systematically with CSR in global supply chains
- They can be considered to be the “social watchdog” – according to their dominant position in the supply chain
- They produce goods for consumers

Bestseller, Inditex Group and H&M all fulfill those criteria, as being worldwide leading fashion companies.

Step 2: Research of reports & Step 3: Establishment of contact/ process information or data

In order to get valid information the companies were asked for an interview. Only one company – Bestseller – offered an opportunity to talk to the CSR – head (see Interview with Anja Bremholm in the Appendix). In her interview, the head of CSR of Bestseller talked about the companies CSR practices and strategies. Unfortunately, Inditex Group and H&M refused to do an interview and only referred to their Internet sources on their web page. According to them, all the information necessary can be downloaded on the Internet. Hence, the only choice available was secondary research on the Internet. Therefore it can be argued about the credibility and validity of that information.

4.2. Bestseller

Bestseller is a Danish textile industry company, founded in 1975 by Merete Bech Povlsen and Troels Holch Povlsen in Ringkøbing. Their brands entail: Jack & Jones, Name it, Mamalicious, Object Collector’s Item, Outfitters Nation, Pieces Selected Vero Moda, Vila and Junarose. It is still a 100% family owned company. Bestseller exports its products on

29 The following section refers to the source: http://www.bestseller.com, 28th of November, 2013
46 markets in Europe, the Middle East, Asia and Canada through 2,520 chain stores, of which 308 are situated in Denmark, and 12,000 external multi-brand stores.

Seen from a global supply chain perspective, the company has chosen to produce their garments and accessories in factories (318 suppliers/834 factories) in India (14%), Bangladesh (19%), Turkey (20%), Italy (1%) and especially in China (38%) (Figure 12).

![Figure 12: Bestseller’s factories](image)

It is an established fact that Asian countries compliance to ethical standards is not universally given. Therefore Bestseller tends to engage in long term relationships with its suppliers to avoid problems concerning their CSR – standards because one of Bestseller’s biggest priorities is their CSR-policy. Furthermore Bestseller has participated in the establishment of Danish Ethical Trading Initiative (DIEH), which is a partnership between the business world, trade unions and NGO’s. The initiative was found in February 2008 and it is the first Danish multi-stakeholder initiative that brings together trade unions, business associations, non-governmental organizations (NGOs) and companies to promote ethical trade and responsible supply chain management among Danish companies.

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30 Bestseller Sustainability Report 2011/12, p.15
4.2.1 Bestseller’s Auditing Program\textsuperscript{31}

Bestseller seeks sustainability within their supply chain and since they have strict guidelines written down in their CoC, the fashion retailer aims total compliance within the supply chain. To make sure that Bestseller’s supplier and their sub-suppliers meet the laws and requirements auditing/monitoring is necessary. Therefore an “Audit Program” with audits every two years as well as a traffic light-system to rate their suppliers, was implemented (Figure 13).

The traffic light system keeps track of the developments made by each individual factory. The results of an additional, independent third-party audit are entered on the online audit form in the Supplier Portal, which includes all suppliers Bestseller is working with. A rating based on the results of the audit will automatically be generated in the system and given to the factory. Red factories will not be accepted for production.

In case of non-compliance the consequences vary according to the specific circumstances, which will be reviewed on a case-by-case basis. If the problems can be prevented and there is a perceived willingness to improve the relationship can be extended. In case of further non-compliance the long-term relationship will be terminated. Dishonesty during the audit (for example, showing fake documentation) is taken very seriously and factories that cannot show an accurate account of the situation during the Bestseller audit will

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{traffic_light_system.png}
\caption{Rating of Bestseller’s suppliers\textsuperscript{32}}
\end{figure}

\textsuperscript{31} The following section refers to the source: BESTSELLER Supplier Guide, p. 7-15

\textsuperscript{32} BESTSELLER Supplier Guide, p. 9
automatically be rated red. Factories that display a thorough and reliable account will not face punitive action, but will be expected to work on improving the situation in collaboration with Bestseller.

4.3. H&M

Hennes & Mauritz (H&M) was founded in 1947. The Swedish company is owned by its investors. Today the fashion company employs approximately 76,000 people. Among the brand H&M, the fashion retailer also owns the following brands: COS, Monki, Weekday, and Cheap Monday. Their clothes and cosmetics are sold in 37 countries with approximately 2,000 stores in total.

H&M does not own any factories; hence the company outsources production to factories (approximately 700) in Europe and Asia. H&M is a member of the Fair Labor Association (FLA) since 2006 and has become an accredited member in 2008, following a two-year assessment process by the FLA. Being an accredited member means that H&M’s Code of Conduct and monitoring program and other related processes have been assessed by the FLA, and are in line with the organization’s standards.

4.3.1 H&M’s Auditing Program

H&M only engages in supplier relationships, where the suppliers and factories sign their CoC. They are looking at first- as well as second-tier suppliers. To become a supplier of H&M, they have to follow the minimum requirements of the code of conduct: absence of forced labor, a ban on child labor, minimum wage, fundamental safety provisions, no use of banned chemicals in accordance with H&M’s Chemical Restrictions, full transparency and full access to all relevant factory areas. “The Full Audit Program (FAP) is the main tool H&M uses to monitor their suppliers compliance with their Code of Conduct. H&M only uses internal as well as external auditing realized by FLA. Once complete the results

33 The following section refers to Bachmann/Ivansits, 2011

34 The following section refers to the source: H&M Conscious Actions – Sustainability Report 2012, www.hm.com
are discussed with the factory management and the supplier and factory being audited are required to draft a correction plan that outlines the timing and responsibilities for correcting areas of noncompliance. A correction plan can include both short- and long-term remediation activities. H&M’s auditors will then check on the implementation of the measures outlined with follow-up audits. Follow-up audits are part of the improvement process and focus on progress made in respect of the correction plan developed following the initial head audit. A full audit cycle typically consists of one head audit and three follow-up audits over a period of 18-24 months. An important part of this approach is to help the supplier understand the value of making improvements and how this benefits their business and their long-term relationship with H&M. This approach often results in greater trust and a better business relationship between suppliers and H&M.” [about.hm.com, 3rd of March 2014]

4.4. Inditex Group

“The Inditex Group […] consists out of more than 100 companies operating in textile design, manufacturing and distribution. The group's success and its unique business model, based on innovation and flexibility, have made Inditex one of the biggest fashion retailers in the world.” [www.inditex.com, 3rd of March 2014]

The fashion group has eight brands with approximately 5,400 stores in 78 countries. The store formats are: ZARA, Pull & Bear, Massimo Dutti, Bershka, Stradivarius, Oysho, Zara Home and Uterqüe. Inditex especially is famous for its “ZARA concept”. Zara is well known in the industry for its fast Just-in-time approach. The fast fashion approach allows fashion products to be in the stores just as the trend emerges. Nowadays Zara is always the first to have the newest trends in the stores and the other stores are following. The first CoC was established in 2001.

35 The following section refers to the source: www.inditex.com
4.4.1 Inditex Group’s Auditing Program

One of the goals of Inditex’s strategy is to ensure the sustainability of its supply chain, both through the fulfillment of the CoC for External Manufacturers and Suppliers, which has been in force since 2001. In order to carry out its policy, Inditex has local CSR teams in India, Bangladesh, Turkey, China, Morocco, Brazil, Portugal and Spain.

In case of being interested in a supplier, the Inditex Group starts with a Supplier self-assessment (pre-assessment). This tool consists of a “document outlining all obligatory requirements, which enables them to self-assess whether they can comply with the Code of Conduct for External Manufacturers and Workshops, product health and safety standards, environmental requirements, and whether they can respond to production needs. At this stage, vendors must sign the Inditex Minimum Requirements before they can receive their first orders from Inditex.” [www.inditex.com, 3rd of March 2014]

After signing the contract with the Inditex Group social auditing, external and internal, is carried out [www.inditex.com]. “This auditing […] includes surprise visits to workplaces, interviews with factory managers, employees, trade union representatives and health and safety representatives, document review (management systems, payroll, hours worked, output, documentation on workers and permits) and assessments of waste management, emissions and resource use. Unauthorized outsourcing deals are forbidden. In the event that a supplier outsources some of its production to other factories, the subcontracted facilities must meet the same Inditex requirements and submit to obligatory Group audits. For the purpose of detecting potential unauthorized subcontract work, Inditex’s CSR teams utilize a range of tools, which help them to assess and compare each supplier's production capacity.” [www.inditex.com, 3rd of March 2014]

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36 The following section refers to the source: www.inditex.com
“Every supplier is assigned a score on its degree of compliance with each of the headings in the Code of Conduct analyzed during the social audit. Inditex sorts vendors into four categories” [www.inditex.com, 3rd of March 2014], as highlighted in Figure 14.

“Inditex’s CSR teams actively support suppliers interested in continuing to work for the Group by designing corrective action plans as a means of resolving possible compliance issues. These plans are always developed with the participation of all involved parties (factory heads, local and international trade unions and Inditex CSR teams). After customized corrective action plans are drawn up for the supplier, monitoring audits are scheduled. These audits include surprise visits and are intended to verify, in accordance with a series of deadlines, that the vendor has begun the agreed-upon improvements. Depending upon the supplier’s rating in the social audit, monitoring audits are carried out on different schedules: A Supplier (max. period of 24 months), B Supplier (max. period of 18 months), C-Supplier (max. period of 12 months) and D Supplier (max. period of 6 months).” [www.inditex.com, 3rd of March 2014]

4.5. Safeguard Mechanisms – Case Study

After Analyzing all Research material based on the interview and the secondary literature, the following Safeguard Mechanisms of the three fashion companies – H&M,

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37 own representation based on Inditex Group Annual Report 2012
Bestseller and Inditex Group – are detected and will be explained in the following sections.

4.5.1 Direct Sanctions

As stated in Chapter 3.5.1 – “When a company imposes direct sanctions on a supplier it has to calculate the indirect costs for the company itself. For instance, the cost of breaking the long-term relationship with the supplier or the cost of lost investments in e.g. improving the working conditions of the supplier. When the costs outweigh the benefits from the long-term cooperation, the direct sanctions are rather unrealistic. Furthermore the implementation of direct sanction can be difficult since non-compliance with the CoC is not always visible” [Pedersen/Andersen, 2006] and it is true for Bestseller.

The company recognizes that while suppliers must live up to the CoC, there are no guarantees that they actually do so. Instead, Bestseller values suppliers who make an effort and show willingness to improve. Bestseller’s perspective is that it is better to keep collaborating with such non-complying factories and in this way contribute to the improvement of their working conditions [Responsible Production – Bestseller, 2011]. Consequently Bestseller is making use of direct sanctions less frequently and only in severe cases of non-compliance with the code of conducts. Bestseller's supplier-rating system is the main instrument that enables the company to react appropriately to non-compliance. For example, firms that act dishonestly during an audit (e.g. showing fake documentation) will automatically be rated red. In less severe cases of non-compliance, Bestseller asks their suppliers to design a development plan on how to improve their shortcomings and asks them to report back regularly [Supplier Guideline – Bestseller, 2011]. In summary, Bestseller is making use of direct sanctions, as a powerful tool to discipline suppliers, less frequently. As described below, it puts more emphasis on other mechanisms like goal congruence or trust.

H&M also uses a rating system for suppliers with assigned scores. So in case of non-compliance, this would not lead directly to immediate supplier rejection. Instead the factories will receive a lower compliance score. The low score can be seen as an incentive to improve in order to get a higher score. According their homepage, there was no valuable information about H&M’s measures in means of direct sanction.
Same holds as well for **Inditex Group**. In case of non-compliance so called follow-up audits are initialized which are carried out according to the classification obtained in the initial audit [Inditex Group Annual Report 2010, 2011]. Those follow-up programs are started to verify whether, within the spaces of time agreed, the necessary action for correction is carried out, or not. The source does not say whether termination is one objective in case of further non-compliance [Inditex Group Annual Report 2010, 2011].

### 4.5.2 Third Party Intervention

**Bestseller** recently changed its auditing/monitoring strategy [Bremholm, 2011]. For many years the company conducted only internal auditing. In order to increase the companies credibility BESTSELLER outsourced the auditing department partly [Bremholm, 2011].

**H&M** is using internal as well as external auditing. “H&M is a member of the Fair Labor Association (FLA), a non-profit organization dedicated to improving working conditions. The FLA brings together multiple stakeholders from buyers, suppliers, NGOs and others to create lasting solutions aimed at protecting the rights of workers and improving working conditions.” [about.hm.com, 3th of March 2014]

“[…]T]he FLA has conducted independent audits of H&M’s suppliers in China and, since 2009, also in Turkey.” [about.hm.com, 3th of March 2014]

**The Inditex Group** is also making use of an internal as well as external auditing system. Inditex supports the suppliers with corrective action plans (stated above) in which the parties involved take part (supplier's management, local and international trade unions and Inditex CSR teams) [Inditex Group Annual Report 2010, 2011].

### 4.5.3 Goal Congruence

**Bestseller** is trying to increase the goal congruence of its suppliers in many ways and engages in a bottom-up approach in implementing its Code of Conduct. Bestseller requires their suppliers to develop their own strategy in how to implement certain requirements and improve working or environmental conditions. Particularly, suppliers should perform their own risk assessment of all facilities to identify areas in need of improvement, and perform periodic self-evaluation checks on own and subcontractor’s facilities. Bestseller is supporting the suppliers and offers organized workshops and
consulting to improve possible shortcomings [Bestseller Code of Conduct, 2011]. The engagement in long-term relationships facilitates this cooperation. Furthermore, *Bestseller* runs an IT-based system, the Supplier-Portal to enable the communication between the company and its suppliers. Here they are also able to view the current status of their factories and the developments that are needed according to the last audit that was done [Bestseller Supplier Guide, 2011]. This strong emphasis on internal communication proves the companies will engage in a dialog with its suppliers and achieve goal coherence. Another way of how *Bestseller* tries to facilitate enhanced goal coherence is by limiting the number of suppliers and sub-suppliers. With a limited number of actors coherence is easier to achieve.

According to *H&M*s homepage, the company wants its suppliers to fully understand their sustainability issues better and wants them to see the benefits of good social and environmental performance. “In the long run, we want our suppliers to take charge of their own sustainability. We call this approach supplier ownership” [hm.com/beyondmonitoring, 2013]

H&M wants its suppliers to be in charge of their own sustainability in the long run, therefore there is a need to involve their employees. They need to know their rights and how to claim them.

“Since 2006, the *Inditex Group* has developed the management of its production chain starting from a structure based on clusters. These working groups are made up of suppliers, manufacturers, trade unions, business associations and international buyers. All of them are interrelated among themselves with the common objective of generating a sustainable productive environment in a strategic geographical area for the development of the Inditex business model.

All the actors involved contribute their capacities and tools for the search for solutions in such strategic aspects as: The development and compliance of the Fundamental Employment Standards, whether national or international. The encouragement of mature industrial relations between the parties involved the promotion of creative and innovative solutions for increasing productivity. The fundamental objective is the sustainable growth of suppliers, achieving the expansion of their competitive potential within a framework based on compliance with Human and Employment Rights.
Over the last few years, the weight of the clusters of suppliers has been increasing until it now represents over 80% of the total production of the Group. The proper administration of these organizations gives Inditex a profound knowledge of how its production chain is evolving. Through these clusters, Inditex is opening up a framework of dialogue with all those agents involved in their activity, a scenario to encourage knowledge and experience in the production chain. The final objective is to give an incentive to the suppliers to offer a good product, at a proper price, at the right moment and produced in appropriate conditions of employment.” [Inditex Group Annual Report 2010, 2011, p. 72]

### 4.5.4 Trust

**Bestseller** - When implementing and safeguarding its global supply chain, Bestseller puts a strong emphasis on deep and long-term relationships with its suppliers. Bestseller understands that mutual trust in the buyer-supplier relationship can be an essential safeguarding mechanism:

“We have worked with many of our biggest suppliers for a very long time, and it is our belief that close long-term relationships are preferable in order to ensure the best COC results. Mutual trust and understanding are the main pillars of a good relationship, and that is not established overnight. It is our impression that the longer we have worked with a supplier, the better he understands the motives behind our COC.” [Interview Anja Bremholm, 2011]
The way Bestseller is integrating CSR-Strategies in its supply chain requires a high degree of self-reliance and autonomous implementation on part of their suppliers. In the case of non-compliance with the COC the company conducts a case-by-case analysis, the consequences depending on the type of relationship, level of trust and the severity of the instance. Bestseller engages in a dialog with its suppliers in order to develop a strategy to improve shortcomings but at the time the supplier is still responsible for successful implementation. These trust-based follow up activities are complemented with certain control mechanisms, like auditing. The intention to lower the number of suppliers and sub-suppliers in its supply chain intends to facilitate strong relationships characterized by mutual trust.

**H&M** focuses on supporting their suppliers by building up management knowledge and capacities and helping them to assess their own performance so that they can detect opportunities to improve their business.

“**Inditex Group** is participating in the most important dialogue platforms in its sector. Thanks to the debate, which is taking place in these platforms, the common activities between Inditex and its stakeholders have been reinforced in order to achieve a long-term relationship with them, based on mutual trust.” [Inditex Annual Report 2010, 2011, p. 78]

### 4.5.5 Reputation effects

**Bestseller** is making use of reputation effects as a safeguard mechanism. All their suppliers are listed in their supplier portal but this information is limited to the suppliers of Bestseller. According to the interview with Anja Bremholm, Bestseller does not want to reveal its suppliers due to competition.

The bottom up integration strategy of the CoC, as described above, shows Bestseller dedication for a strong dialog and long-term relationships. The company aims to establish long-term and close relationships with its suppliers [Bestseller Supplier Guide, 2011]. Putting an emphasis on intensive dialog enables Bestseller to convince the suppliers that compliance with the CoC and therefore acting as a reliable partner is beneficial to them. Future long-term benefits can outweigh the costs of acting responsible.

Nevertheless obvious shortcomings in Bestseller’s social responsibility reporting hinder the efficient usage of reputation effects as a safeguard [Bestseller Supplier Guide, 2011]. The lack of transparency in the corporate social reporting can diminish a company’s
reputation [Hess, 2008]. An unfavorable reputation of the CSR-Initiating company itself does not help to integrate sound CSR-Strategies throughout the supply chain. H&M is making usage of the reputation effect by sharing the information with all their shareholders. Same holds as well for the Inditex Group.

4.6. Transparency

According to Koch (1995) and Pedersen and Andersen (2006) the paper explained the theoretical value of reputation effects, trust, goal congruence, third party interventions and direct sanctions and this mechanisms are used analyze how Bestseller, H&M and the Inditex Group are making use of them. In the following paragraph it will be shown how these safeguard mechanisms can be amplified by introducing another safeguard mechanism, transparency.

As described above, informational asymmetries between the principal and the agent after the contract is signed, leads to the risk of moral hazard and opportunistic behavior. A high degree of transparency, first in the relationship between principal/buyer and agent/supplier and second in the relationship between buyer and its stakeholders, can essentially help to safeguard the CoC by lowering informational asymmetries between the parties. Transparency in the buyer-supplier relationship requires that the supplier discloses all its production facilities, production processes and allows audits at any given time. If

\[39\] own representation based on Bachmann/Ivansits, 2011
suppliers have to meet high transparency standards in order to be accepted as a supplier, buyers can lower their audit efforts and benefit from considerable cost-savings. Increased transparency in this regard can lead to a higher level of trust in the relationship and thus amplifies the functionality of this safeguard mechanism.

On the other hand, a transparent buyer-supplier relationship requires that the buyer discloses and communicates the results of conducted audits to its suppliers; this leads to an intensified dialogue between the two parties. Long-term relationships and the fostering of intensive dialog are essential to relay on goal coherence and trust as efficient safeguard mechanisms.

The additional introduction of industry wide supplier portals, where suppliers have to reveal their social and environmental production practices is conceivable [Pedersen/Andersen, 2006]. A consequent usage of such a portal could encourage competition among the suppliers. An outstanding performance regarding CSR-Measures would be rewarded by an increased amount of orders and could lead to a competitive advantage of well performing suppliers. Suppliers would be in a position where they can signal COC compliance to the whole industry network. Thus, reputation effects as an important safeguard mechanism will gain increased importance if higher levels of transparency are introduced industry-wide.

Transparency in the relationship between a company and its stakeholders is morally important because it enhances an attitude for honesty, openness, and commitment to truth. It can be argued that transparency enhances the accountability and responsibility of a firm [Dubbink/Graefland/Liedekerke, 2008]. Transparency makes it easier to for stakeholders to confront a company with its actions. Therefore, transparency enables effective third party monitoring – the public can act as a monitoring party. Audit activities, previously undertaken by the company can partly be shifted to different stakeholders outside the firm. In this regard, transparency works as additional safeguard mechanism and helps to get suppliers in line with the companies COC.

Nevertheless, full transparency can also be harmful for a company. Disclosing information may lead to a strategic disadvantage of the company. For achieving transparency in the relationship between a company and its stakeholders Hess (2008) defines certain pillars, central for a sound corporate social reporting strategy. Hess’s discloser pillar requires that corporations provide their stakeholders with all relevant and
material information relevant to the corporation's social and environmental policies [Hess, 2008]. This includes information about all active suppliers, including their production facilities, production processes as well as the results of audits undertaken. The question remains if firms rather try to activate potential benefits or if the focus on the possible addition costs of engaging in transparent relationships.

**Bestseller** is making use of transparency as an effective safeguard only partially. The company puts a strong emphasis on transparency in the relationship with its suppliers but shows substantial shortcomings on corporate social reporting and the relationship with its external stakeholders can be characterized as non-transparent.

The company requires that all suppliers’ production sites entered into the audit program prior to the integration in the supplier portal and the placement of orders. Suppliers should ensure that factories are open and honest during audits and that the auditor is allowed full access to the site and the true records. Bestseller uses its supplier rating system in order to track if suppliers are in compliance with the companies COC. The results get communicated through its supplier IT-Portal. Furthermore, the company’s engagement in long-term relationships and strong dialog facilitate the development of a transparent supplier-buyer relationship.

Bestseller shows substantial shortcomings when it comes to transparency in the relationship with other external stakeholders. The corporate social reporting is inadequately. It is important to notice that from the website communication, it is impossible to know if the majority of Bestseller's suppliers are at the top of the Bestseller rating scales or at the bottom. Hence, the rating scales would be much more relevant for external stakeholders if Bestseller also communicated their results and not only the fact that it exists. Also, Bestseller is unwilling to publish the names of their suppliers for competitive reason [Bremholm, 2011].

The lack of transparency makes it impossible for stakeholders to critically assess the companies CSR-Measures and undermines the company’s credibility. Thus, Bestseller neglects possible benefits of involving the public and other stakeholders in audit process and resigns to use transparency as an efficient and cost-effective safeguard mechanism.

**H&M** on the other hand is making use of a strong dialogue with its stakeholders to tighten their standards and further extend their positive results in CSR-efforts. In opposite to
Bestseller the fashion retailer publishes a Sustainability Report annually and is engaged in campaigns for marketing reasons.

“Close collaboration with our stakeholders, both internal and external, is essential in enabling us to tackle the challenges we face throughout our value chain.” [H&M-Conscious Actions, 2011]

“The Inditex Group, in order to achieve maximum corporate transparency, in addition to including all relevant information and communications on its website, Inditex has kept the market regularly posted during fiscal year 2011 through the submission of the relevant “Results releases” (circulated to a large number of investors, analysts and media specializing in the stock markets, “Press releases” (sent to the media and PR agencies), as well as via webcast conference-calls and roadshows, conducted pursuant to the recommendations of the CNMV included in its letter dated 22 December 2005, “Recommendations on information meetings with analysts, institutional investors and other stock market professionals”, for the purposes of preventing a selective dissemination of relevant information and observing the principle of equal treatment to all investors.” [Inditex Annual Report 2010, 2011, p. 53]

4.7. Conclusion – Case Study

The previous case study was derived with second research analysis based on sources like the internet and reports. The case study concludes that Bestseller, Inditex Group and H&M are all engaged in certain CSR activities and make use of certain safeguard mechanisms to establish compliant behavior. Nevertheless some of them seem more authentically engaged than the other companies.

The following overview, displayed in Table 2, summarizes the number of and exactly which safeguard mechanisms are used in the fashion companies supply chain.
It can be said, that all of the three companies are using at least more than three of the mechanisms implemented by Pedersen and Andersen (2006), given the risks for the “supply chain watchdog”, such as H&M, Inditex or Bestseller, to suffer a scandal, which has the biggest after-effects on them, causing decrease in their reputation and credibility - certain measurements have to be developed to maintain compliance.

Nevertheless Bestsellers CSR – strategies seems to have the most loopholes:

- Lack of transparency
- Lack of reputation effect

While H&M and the Inditex Group obviously understand the necessity to give suppliers appropriate incentives, Bestseller neglects the use of specific important safeguarding mechanisms. Since there is no disclosure of Bestsellers suppliers and sub-suppliers, the mechanism of reputation effects helps only to a limited extent to safeguard the companies COC. Transparency, first in the relationship between the principal and the agent and second in the relationship between buyer and its stakeholders, is missing. Shortcomings in this regard limit the efficiency of existing safeguard mechanisms. Suppliers cannot gain competitive advantage by acting responsibly if their actions are not visible to the market. At the same time the public cannot help to safeguard the supply chain if proper reporting for customers is not available.

\[\text{Table 2: Conclusion of Case Study}^{40}\]

<table>
<thead>
<tr>
<th>Company</th>
<th>Direct Sanctions</th>
<th>Third Party Intervention</th>
<th>Goal Congruency</th>
<th>Trust</th>
<th>Reputation Effect</th>
<th>Transparency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bestseller</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>H&amp;M</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Inditex Group</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
</tbody>
</table>

\(^{40}\) own representation
Hence, Bestseller obviously is having some trouble to incentivize its suppliers and will probably show the worst results in successfully implementing their CoC.

But, due to the lack of consequences (Chapter 1), there is no incentive for the company itself to fix their loopholes in safeguard measurements. It would simply cost more money and effort than is it necessary.
5. PRINCIPAL-AGENT – THE MODEL

As presented in Chapter 4, the information asymmetry in a principal – agent situation leads to either adverse selection or and moral hazard situations.

This chapter focuses on the principal agent theory with special focus on the problem of moral hazard. Chapter 6 will use the following demonstrated model as the basis for the PAM (principal – agent model) with respect to CSR, as it will be remodeled or complemented. For further simplifications, only the abbreviations of principle, for short P, and agent, A, will be used.

“Economics began to look more carefully at the firm, either in agricultural economics or in managerial economics, incentives became central.”[Laffont/Martimort, 2001, p.11]

5.1. The principal-agent model with moral hazard

The goal of the principal – agent theory is to efficient formulation of a contract between A and P and their costs involved [Jost, 2001, p.45].

In the following section the design of the optimal contract between A and P will be mathematically derived.

As described in Chapter 3, the occurrence of asymmetric information leads to several problems within a principal – agent setting. This thesis will only discuss the problem of moral hazard.

Hence, the following PAM in a moral hazard setting will later be used for remodeling in a CSR setting.

First it has to be discussed, why a model with moral hazard will be used?

Moral hazard results from a situation in which a hidden action occurs [Laffont/Martimort, 2001, p.20]. In this context P can only design a contract based on A’s observable performance. Through this contract, P wants to induce, at a reasonable cost, a good action of the agent despite the impossibility to condition directly A’s reward on his action [Laffont/Martimort, 2001, p.148]. In general, the non-observability of A’s effort affects the costs of implementing a given action [Laffont/Martimort, 2001, p.148].
The following model will highlight the situation where a risk-averse $A$ can choose a certain effort with an effort level, which is either high or low. Of course the goals of $P$ differ from those of the agent. $P$ aims to contract $A$ under the condition of implementing positive level of action at minimal cost.

The moral hazard problem is resulting due the assumption that $P$ cannot observe the agent’s behavior. Further it is assumed that the profit based on $A$’s effort is observable and verifiable. Therefore the connection between payment to $A$ and $A$’s performance will be created. To rule out the adverse selection problem, $P$ is making use of screening and signaling to find out the type $\theta$ of the $A$ before contracting.

For the model the following characteristics are assumed [Jehle/Reny, 2001; Jost, 2001]:

- The timing is as follows:
  - Stage 1: $P$ offers contract
  - Stage 2: $A$ either accepts or rejects the offer
  - Stage 3: $A$ exerts a certain effort level, $e$
  - Stage 4: according to $e$, a certain output ($x$) is realized
  (Stage 3 ½ (monitoring/auditing) will be neglected in this model and further discussed in Chapter 6)

- $P$ is risk-neutral. $P$ is uninformed due to the fact, that the exerted effort level of $A$ is not observable (asymmetric information). Only with incentives $P$ can aim to control the effort level, $e$.

- $A$ is risk-averse. $A$ is informed about his effort level. It is assumed that certain types (efficient and inefficient types, $\theta$) do not exist (signaling, screening). $A$ has to exert an effort level that influences positively the utility of $P$ as well as the agent.

### 5.1.1 The complete information optimal contract

First a PAM in a moral hazard context will be introduced based on Jost (2001), Laffont/Martimort (2001), Sappington(1991), Schweinzer (2009) and Jehle/Reny (2001):

- $P$ offers $A$ a contract. $A$ can either accept or refuse the contract. By accepting it, $A$ gets delegated a certain task. This task includes $A$ producing a good $X$.

- $A$ can exert an unobservable effort: $e$

$$ e \in \{e_H, e_L\} \quad (5.1) $$
• Of course the exerted effort has influence on the observable production $x$ [Bolton/Dewatripont, 2006].
As stated above, the Moral Hazard problem discusses the fact, that $A$’s effort level cannot be observed by the principal [Bolton/Dewatripont, 2006]. Hence, the principal can only recommend $A$ which effort level to exert. Therefore it is assumed that $x$ is observable and verifiable and it includes that $A$’s payment is linked to $x$ [Jost, 2001, p. 46].

• It is assumed to have two output levels:

$$ X \in \{x_L, x_H\} \quad (5.2) $$

Only if $x_H$ is reached, the production was successful [Schweinzer, 2009, p.20].

• Exerting effort has a downside as well. Hence $A$ is facing costs, denoted as $g(e)$. $g(e)$ can further be titled as $A$’s disutility.

• The stochastic influence of $e$ on $x$ is characterized by the following possibilities [Laffont/Martimort, 2001, p. 151]

$$ p(e_H) = p(x_H|e_H) \quad (5.3) $$

$$ 1 - p(e_H) = p(x_L|e_H) \quad (5.4) $$

$$ p(e_L) = p(x_H|e_L) \quad (5.5) $$

$$ 1 - p(e_L) = p(x_L|e_L) \quad (5.6) $$

**Principal’s Utility:**

Let $t$ be the compensation for $A$.

The principal is receiving a certain good, but the counter-trade is that $A$ receives certain remuneration [Schweinzer, 2009, p.20].

$$ U_P = V = x - t \quad (5.7) $$

Linking $t$ to $x$, $P$ will offer a contract that is based on the output ($x$). Hence, $P$ is paid according to $x$. Since $x \in \{x_H, x_L\}$, we define two possible $t$’s:

$$ t \in \{t_H, t_L\} \quad (5.8) $$

Now the expected utility of $P$ writes as follows (depending on either $e_H$ or $e_L$):

$$ V(e_H) = p(e_H) \times (x_H - t_H) + (1 - p(e_H)) \times (x_L - t_L) \quad (5.9) $$

$$ V(e_L) = p(e_L) \times (x_H - t_H) + (1 - p(e_L)) \times (x_L - t_L) \quad (5.10) $$
Since there are two effort levels, it is \( P \)'s choice which \( e \) should be induced in the optimal first best contract.

**Agent's Utility**

A's goal is to maximize its expected utility [Jost, 2001, p 47]. The expected utility depends positively on \( t \) and negatively on his effort level \( e \) [Jost, 2001, p 47].

\[
U_a(x,e) = u(t) - g(e) \quad (5.11)
\]

\( g(e) \) is the disutility (costs) facing for exerting a certain \( e \).

\( v(\cdot) \) is an upward concave function, hence A is risk averse [Collard-Wexler, 2012, p, 5]. Given that there are always pairs, \( \{e_H, e_L\}, \{t_H, t_L\} \) and \( \{x_H, x_L\} \), the utility of A is the following:

\[
U_a = p(e_i) \times u(t_H) - (1 - p(e_i)) \times u(t_L) \quad (5.12)
\]

Hence the utility for A with \( e_H \) is:

\[
U_a = p(e_H) \times u(t_H) - (1 - p(e_H)) \times u(t_L) \quad (5.13)
\]

**Individual Rationality constraint (IR):**

The individual rationality constraint is also called *participation constraint*. In this model it is assumed that A could achieve a utility of \( U_r \) (reservation utility) to alternative contract offers [Jost, 2001, p.28]. \( U_a \) has to exceed \( U_r \) in case of a successful execution of contract [Jost, 2011, p.48].

This means, that A only accepts the contract, if \( u(t) - g(e) \) exceeds the utility of a different option, such as a different contract or unemployment money.

\[
u(t) - g(e) \geq U_r \quad (5.14)
\]

For simplicity is assumed that:

\[
u(t) - g(e) \geq 0 \quad (5.15)
\]

Given equation 5.12., the IR for \( e_H \) is now the following:

\[
p(e_H) \times u(t_H) - (1 - p(e_H)) \times u(t_L) - g(e_H) \geq 0 \quad (5.16)
\]

**Incentive compatibility constraint (IC):**
By designing the contract $P$ has to make sure that $A$ is participating after signing the contract and it is guaranteed that $A$ exerts the efficient effort level $e$ [Jost, 2001, p.48].

This reflects the moral hazard situation; because subsequently it follows that $A$ chooses his effort level for maximizing his utility $U_a$ after signing the contract [Jost, 2001, p.48]. The contract has to fulfill the following constraint in the case that $P$ wants $A$ to implement $e_H$

$$p(e_H) \ast u(t_H) - (1 - p(e_H)) \ast u(t_L) - g(e_H) \geq p(e_L) \ast u(t_H) - (1 - p(e_L)) \ast u(t_L) - g(e_L)$$ (5.17)

5.1.2 First-Best Solution – Symmetric Information

In this section the existence of asymmetric information is neglected. The effort level exerted by $A$ is observable. According to the missing information problems, $A$‘s behavior can be controlled with the help of a contract. Hence, this section aims to find the optimal $t(e)$ for maximizing $P$’s utility under the condition that $A$ receives his reservation utility.

Further it seeks to find out which effort level should induced Rady, 2007

In case of observing $e$ of $A$, $A$ will get the remuneration ($t$) according to $e$.

Optimization problem:

$P$’s goal is profit maximization. The contract specifies the effort level $e$, and $A$’s compensation $t$ depends on the result of the task, $x$. The principal objective function therefore is stated as follows [Jost, 2001, p.47; Schweinzer, 2009]:

$$\max_t p(e_i)(x_i - t_H) + (1 - p(e_i))V(x_i - t_L)$$ (5.18)

(IR) $p(e_i) \ast u(t_H) - (1 - p(e_i)) \ast u(t_L) - g(e_i) \geq 0$ (5.19)

Now it is assumed that $P$ wants $A$ to exert $e_H$. Hence, $P$’s maximization problem is denoted as:

$$\max_t p(e_H)(x_H - t_H) + (1 - p(e_H))V(x_H - t_L)$$ (5.20)

(IR_H) $p(e_H) \ast u(t_H) - (1 - p(e_H)) \ast u(t_L) - g(e_H) \geq 0$ (5.21)

Next step is to solve the problem with the help of the Lagrangian approach:
\[
L(t(x_t), \lambda) = p(e_H)(x_H - t_H) + (1 - p(e_H))V(x_H - t_L) - \lambda [p(e_H) * u(t_H) - (1 - p(e_H)) * u(t_L) - g(e_H)]
\]

\(\lambda\) is the multiplier of the IC.

The 1\textsuperscript{st} order conditions with respect to \(t_H\) and \(t_L\) now leads to the following first order conditions [Laffont/Martimort, 2001, p. 153]:

\[
\begin{align*}
-p(e_H) + \lambda * p(e_H)u(t_H) &= 0 \quad (5.22) \\
-(1 - p(e_H)) + \lambda * (1 - p(e_H))u(t_H) &= 0 \quad (5.23)
\end{align*}
\]

From 5.22 and 5.23 it can be easily derived that \(\lambda = \frac{1}{u(t_H^*)} = \frac{1}{u(t_L^*)}\) and finally that \(t^* = t_H^* = t_L^*\) [Laffont/Martimort, 2001, p. 153].

Hence, the optimal \(t\) of a risk-averse \(A\) is constant and not dependent on the production \((x)\). Given the fact that \(P\) is risk neutral, it implies that he is having all the risk.

Looking at \(P\)’s utility function \((x - t)\) it becomes really clear that \(t\) minimizes \(P\)’s profit. Therefore the best strategy is to keep \(t\) as low as possible [Jost, 2001, p.52]. Of course \(A\)’s utility has to be bigger than \(U_r\).

\(P\)'s payoff now is denoted in equation 5.24:

\[
V(e_H) = p(e_H) * x_H + (1 - p(e_H))x_L - t_H^* \quad (5.24)
\]

\[
V(e_L) = p(e_L) * x_H + (1 - p(e_L))x_L - t_L^* \quad (5.25)
\]

The conclusion of the First Best-problem with symmetric information is, that a contract includes \(t\) that is based on \(e\) and not on \(x\).

5.1.3 Second-Best Solution – Asymmetric Information

In this section it is assumed that the effort level, exerted by \(A\), is not observable.

According to Jost (2001) the derivation of the solution is based on the two-stage analysis of Grossman and Hart (1983): firstly the contract, which implements the determined \(A\)’s effort level at minimal costs, is observed. Therefore the optimal remuneration system for each \(e\) is identified.
Second step is the determination of the optimal effort level $e^*$ of $A$ based on the optimal compensation $t^*$ [Jost, 2001].

\textit{P wants to implement a contract that A exerts $e_h$ optimally:}

In this case the IC is not binding. $P$ does not have to give $A$ the incentive to exert $e_h$. It is assumed that $A$ is risk averse and therefore the conclusion of the first best contract is identical in this case.

\textit{P wants to implement a contract that A exerts $e_h$ optimally:}

Equation (5.7) – $P$’s maximization problem - is modulated again:

\[
\begin{align*}
\max_{t(x), e^*} & \quad p(e_H) V(x - t_H) + (1 - p(e_H)) V(x - t_L) \\
(\text{IR}_H) & \quad p(e_H) u(t_H) + (1 - p(e_H)) u(t_L) - g(e_H) \geq U_r \\
(\text{IC}_H) & \quad p(e_H) u(t_H) + (1 - p(e_H)) u(t_L) - g(e_H) \geq p(e_L) u(t_L) + (1 - p(e_L)) u(t_H) - g(e_L) \\
\end{align*}
\] (5.26)

\[
\begin{align*}
\quad & \quad \lambda [p(e_H) u(t_H) + (1 - p(e_H)) u(t_L) - g(e_H)] \\
+ & \quad \mu [p(e_H) u(t_H) + (1 - p(e_H)) u(t_L) - g(e_H) - p(e_L) u(t_L)] \\
- & \quad (1 - p(e_L)) u(t_H) + g(e_L) \\
\end{align*}
\] (5.27)

\textit{Lagrangian approach – implementing $e_h$:}

A new variable, $\mu$, denotes the multiplier of the incentive constraint. In combination with the multiplier $\lambda$ of the participation constraint, the Lagrange function of the maximization problem can be written as follows [Jost, 2001, p.56]:

\[
L(t(x), \lambda, \mu) = p(e_H) V(x - t_H) + (1 - p(e_H)) V(x - t_L) \\
+ \lambda [p(e_H) u(t_H) + (1 - p(e_H)) u(t_L) - g(e_H)] \\
+ \mu [p(e_H) u(t_H) + (1 - p(e_H)) u(t_L) - g(e_H) - p(e_L) u(t_L)] \\
- (1 - p(e_L)) u(t_H) + g(e_L)
\]

\textit{First order condition leads to:}

\[
\frac{1}{u'(t^*(x))} = \lambda + \mu \left[ 1 - \frac{p(x|e_L)}{p(x|e_H)} \right]
\] (5.28)

- In case of implementing $e_h$ the result is inefficient [Rady, 2007]. In section 5.1.1 the result of the first – best contract was, that the risk-averse $A$ was secured totally and $P$ suffers all the risk. In the case of asymmetric information and implementing of high
effort, the risk-averse $A$ will not be entirely covered. Hence $P$’s strategy is to offer $A$ a fixed compensation $t^*(x)$ and a risk premium.

- **Both, IC and IR have to be binding:**
  Otherwise the first – best solution remuneration scheme will be used.

In case of implementing $e_H$ and a risk averse $A$ the risk allocation now can not be allocated totally to $P$. Therefore $P$ has to pay a risk-premium in order to cover $A$’s risk. The second-best contract tries to manage equilibrium between optimal risk allocation and optimal incentives [Schweinzer, 2007].
6. PRINCIPAL-AGENT – THE CSR MODEL

In this chapter it is attempted the influence on implementing CSR-norms within a principle-agent setting. Further it tries to evaluate the changes in P’s payoff when auditing is involved. The characteristics of this contract and the role of Auditing will be discussed.

A compliance level (GCC = Goal congruency correction factor) will be invented. The GCC is based on some of the Safeguard mechanisms introduced in Chapter 3. With the help of the GCC it will be demonstrated how A’s benefit is changing when he is compliant with the implemented CSR measures. Auditing will be included and depending on the outcome of the audit and its success changes in A’s outcome can be seen. Further, several levels of probability of detecting will be invented and it will be shown how the level of probability influences P’s payoff.

Section 6.5, in contrast to 6.4, takes the approach by arguing, that with including an audit mechanism, we will find ourselves in a situation of symmetric information and therefore we can reach the first-best solution, if the transfer t is dependent on to the effort level e and there is full observation due to Audits. Further the first-best model is calculated, neglecting auditing.

But this solution seems to neglect the fact, that audits have a certain error rate. In the model in section 6.4.2 is assumed that an audit will find every tiny violation, why else in reality, bribe and fake documentation as well as sloppy review, may change the result of the audit. Hence, it may be, that A, who committed a number of violations, simply made it through an audit without getting caught. Where else another A, gets accused of low wage, due to wrong paper work, even though he did everything all right.

Therefore it will be taken a different approach in Section 6.4, by introducing probabilities for a positive as well as a negative audit (asymmetric information setting) in P’s objective function. It will be shown that the payoff increases, when the probability of positive audit increases as well.
What are the differences to the normal principle agent model?

The classical PAM is concerned about the quality of the manufactured products since $A$’s effort level should affect it. This problem has been analyzed in Chapter 5 and a lot of scientists and literature have already developed mechanisms to cope and deal with the situation. But all attention that has been given to the topic CSR has not yet led to a common mechanism to cope with the issue of non-compliance. To overcome the issue of non-compliance auditing is implemented.

Further it is assumed that in case of asymmetric information, auditing might only lead to a certain extend to the truth and true action of $A$.

The aim now is to find out if the probability of a positive audit (vs. negative audit) has a huge impact on the utility of $P$. The big challenge in this model is to define $P$’s utility of auditing (using safeguard mechanisms) due to the fact that the utility of auditing is hard to quantify. This problem will be further discussed in Section 6.3.

6.1. Characteristics:

It is considered to have two participants in the model. First there is $P$ (Bestseller, H&M or Inditex Group). As discussed before, according to Bestseller/Inditex Group/H&M’s special characteristics, determined in Chapter 1, the fashion companies are considered to be the „social watchdogs“, they are considered to have the bargain power within the supply chain.

Further there is a supplier, who is contracted for producing garment. As a matter of fact, producing in India is much cheaper; hence $P$ contracts the supplier in India. The supplier in India is now considered to be $A$.

$P$ has a certain CoC and he wants $A$ to act according its standards. The CoC characteristics will be discussed in detail in section 6.1.

Now it is assumed that $A$ is producing $x$ for $P$. Very importantly $P$ wants $A$ to be compliant to $P$’s CoC. Implementing a CoC bears some costs for $A$, since certain standards have to be obeyed. Therefore the disutility of obeying the CoC of $A$ rises and hence the probability of cheating the CoC standards rises.
The relationship of supplier and fashion company in a CSR-setting can be seen as a typical principal-agent relationship under asymmetric information and therefore bears the risk of moral hazard. Hence $P$ can simply not observe $A$’s actions $e$.

By the mere fact of delegating the production outside the company, the principal loses any ability to control those actions; hence in case of using underpaid labor or polluted garment, $P$ will simply not know.

This problem leads to multiple optimization problems, which have to be solved, even though there is a limited data set available.

$$U_a \neq U_p$$

As described in Chapter 3 there are some measures to mitigate cheating (safeguard mechanisms) and especially two of them will be used for formulating the principal-agent model with respect to CRS: Third Party Intervention aka Auditing.

Hence, to overcome the problem of non-observing $A$’s action, auditing will be included to test, whether $A$ is working according the standards or not or at least what can be done better. Further, based on additional safeguard mechanisms, the reward will be compliant behavior. This factor for being compliant is called GCC and will be introduced in detail in Section 6.2.

### 6.2. Characteristics

The following characteristics have to be defined:

- Bestseller/H&M/Inditex Group is the chain directors who contracts $A$
- Bestseller/H&M/Inditex Group has implemented a CoC that includes legal, environmental and health and safety issues
- Bestseller/H&M/Inditex Group contracts new suppliers, but within negotiation they convince their partners to use the SA8000 standards (see Appendix) or internal standards (such as in case of Inditex Group and H&M with the minimum requirements described in Chapter 4)
  - This should solve the adverse selection problem when negotiation issues in a new contract, because $A$ signals compliancy
  - The minimum requirements are:
    - absence of forced labor
o ban on child labor

• Since Bestseller, H&M and Inditex Group are interested in long-term relationships. They know that it involves development to keep up with their standards, they rate their agents according to a traffic system (Figure 19).

![Figure 17: Traffic System of Rating](image)

• Even though the minimum requirements are fulfilled, audits are keeping track of their actions, but audits are not done on every – day basis; hence A’s behavior is not fully observable between the periods of audits.
  ▪ Audits are not announced. A can take precautions to pretend being compliant. So bribe of the interview partner o wrong prepared numbers and other precautionary measures can be set up to pretend a different picture. Therefore it is assumed that incompliant behavior (cheating) cannot be detected with 100 %.
  ▪ Non-compliance can be detected with a probability of 40%

• Auditors supervise the following factors:
  ▪ Environmental Factors:
    o Chemicals restrictions
    o Recycling
    o Water waste
  ▪ Legal Factors:

---

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6.3. **Goal Congruency Correction Factor**

As described in Chapter 3, one of the Safeguard Mechanisms (third party intervention = auditing) is now going to be implemented in the PAM (Chapter 5). To find out whether A is cheating and pretending to be compliant can only be found out by auditing, in the case of asymmetric information

According to Chapter 4, H&M, Bestseller and Inditex Group are making use of third party intervention to make sure that their standards are well implemented in their production supply chain.

To endow the suppliers with incentives to overcome the principle-agent model measures to increase goal congruence is crucial to lower the risk of moral hazard. This fact is now used formulize the PAM with respect to CSR, because it is not enough if the initiating firm has a strong interest in implementing CSR-Strategies; it also has to convince its suppliers, that such a behavior is preferable [Pedersen/Andersen, 2006]. It can be achieved in many different ways. The initiating company can compensate its suppliers for the costs social and environmental enhancing strategies may cause, and this is done with the help of the GCC [Pedersen/Andersen, 2006].

The goal congruency is based on all values of the company mentioned in a code of conduct. In section 6.1 the characteristics of the CoC were displayed. It is assumed that the following textile industry issues are targeted:

- absence of forced labor
- ban on child labor
- minimum wage
- fair working hours

- Health and Safety
  - Fire Escape
  - Ventilation
  - Noise Management
  - Extreme Temperatures
Environmental issues include the resources used for production and the further processing as well as the possibility of recycling the products, productions side-product and the waste management.

Health and Safety issues include all matters concerning the employees. In case of fire, there has to be a fire escape. Further important factors are ventilation, noise management and extreme temperatures.

Social issues especially concern Human rights. All suppliers have to obey to those rights, including the child labor prevention. As discussed in Chapter 3 child labor, fair salary and working hours are among the most occurring issues in the fashion industry.

The following factors are assumed:

\[ f_S = \frac{\sum c_S}{N} \quad (6.1) \]

The social factor \( f_S \) is the sum of certain weighting factors \( c_S \) divided by the number of subcategories. Each subcategory can be chosen individually, depending on the importance and the CoC of the fashion company.

Hence, we can say the same for the environmental factor:

\[ f_E = \frac{\sum c_E}{N} \quad (6.2) \]

\[ f_H = \frac{\sum c_H}{N} \quad (6.3) \]

The similar structure of \( f_S, f_E \) and \( f_H \) provide the possibility to rearrange the factors depending on the CSR guidelines as well as a reduction of the quantity of \( c_i \) which leads to a simplification. So according to the size of data set the before stated assumption enables to modify the model according to the various contents of a CoC.

\[ 1 - \frac{\sum f_i}{N} = \text{GCC} \quad (6.4) \]

Compliant behavior leads to monetary reward. Depending on the GCC and hence the traffic light, \( A \) gets paid a certain additional reward (in addition to \( t_{fix} \)), that is based on his \( t_{fix} \). Thus \( t_{fix} \) is chosen be low.

\[ t = t_{fix} + t_{var} \quad (6.5) \]

\[ t_{var} = t_{fix} \times \text{GCC} \quad (6.6) \]
Let’s assume a company that gets unannounced visits of the external auditor: Certain irregular practices are detected. In that case the supplier gets rated according to the GCC, depending on the violation (GREEN, ORAGNE or RED).

- If \( A \) is rated GREEN, it can be said, that receives \( t_{fix} + (t_{fix} \times 100\%) = t \). In this case \( A \) receives twice the wag.
- In case \( A \) receives an ORANGE rating the factor of GCC is between 80-10%.
  \[
  t_{fix} + (t_{fix} \times GCC) = t \quad (6.7)
  \]
- In case of less than 10% \( A \)’s \( t = t_{fix} \) and the GCC equals 0.
  \[
  t_{fix} + (t_{fix} \times 0) = t \quad (6.8)
  \]

In the model with respect to the PAM, the GCC is a factor that increases \( A \)’s \( t \); hence it is a reward for being compliant.

---

### Figure 18: Traffic system with degree of incompliance

6.3.1 Computation of the GCC

To compute the GCC (Goal Congruency Correction factor) the following weighting factors \( c_E, c_S \) and \( c_H \) for environmental, social and health and safety factors have to be pre-established.

Every company can establish an individual weighting system according their own CoC.

Given the following example with pre-established factors, it can be demonstrated how to calculate the GCC (Table 3):

---

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<table>
<thead>
<tr>
<th>FACTORS</th>
<th>FOUND AT AUDIT</th>
<th>WEIGHTING FACTOR $c_i$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Environmental Factors</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Chemicals restrictions</td>
<td>✓</td>
<td>0,5</td>
</tr>
<tr>
<td>Recycling</td>
<td>✓</td>
<td>0,6</td>
</tr>
<tr>
<td>Water Waste</td>
<td></td>
<td>0,5</td>
</tr>
</tbody>
</table>

$$ f_E = \frac{\sum c_E}{N} \quad f_E = \frac{0,6 + 0,5}{3} = 0,37 $$

| Social Factors          |                |                        |
| Absence of forced labor |                | 1                      |
| Ban on child labor      |                | 1                      |
| Minimum wage            |                | 0,9                    |
| Fair working hours      | ✓              | 0,9                    |

$$ f_H = \frac{\sum c_H}{N} \quad f_H = \frac{0,9}{4} = 0,225 $$

| Health and Safety Factors |                |                        |
| Fire escape              |                | 0,5                    |
| Ventilation              | ✓              | 0,7                    |
| Noise Management         |                | 0,4                    |
| Extreme Temperatures     | ✓              | 0,7                    |

$$ f_H = \frac{\sum c_H}{N} \quad f_H = \frac{0,7 + 0,7}{4} = 0,35 $$

$$ 1 - \frac{\sum f_i}{N} = GCC $$

$$ GCC = 1 - \frac{0,37 + 0,225 + 0,35}{3} = 0,315 \approx 0,32 = 0,68 $$

Table 3: Computation of the GCC Factor\(^{43}\)

---

\(^{43}\) own representation
Given Table 3 this company would have a GCC of 68% based pre-established weighting factors. This rating would bring A an orange traffic light rating. So in case of finding out that A was compliant, he would receive $t_{fix} + (t_{fix} \times 0.68)$.

6.4. The PAM with CSR

This section will formulize the principle agent model with respect to CSR by implementing an audit mechanism including a reward system. The reward system is based on the safeguard mechanisms.

*The relationship of P and A is formalized as follows:*

*Stage 0:* With the help of screening and signaling the type $\theta$ of $A$ is detected. Hence, the problem of adverse selection is anticipated.

*Stage 1:* $P$ offers $A$ a contract

*Stage 2:* $A$ either accepts or rejects the contract

- The contract includes a CoC.
- The contract has to exceed $A$’s reservation utility $U_r$.
- In case of accepting the offer, it is contracted upon $A$’s effort level $e_i, i \in \{H, L\}$. Hence, $A$ can either exert $e_H$ or $e_L$. The effort level in asymmetric information is not observable. In a symmetric environment $A$’s action can be observed.

*Stage 3:* $A$ exerts a certain effort level

$A$’s effort level affects $x$. The set of $x$ is denoted by $x_i \in X$ and $i = \{H, L\}$ where

- Exerting effort has a price. $A$ faces the costs: $g(e_i)$

*Stage 4:* Since $A$’s effort level is not observable (in a second best setting) third party auditing is used to verify $e_i$.

According to Figure 21 the level of incompliance ranks the supplier ($A$) according a traffic light system. As described before, when GCC is above 80% $A$ will receive the full remuneration (GREEN). When it is between 10-80% $A$ will get $t + (t \times GCC)$(ORANGE). In case of $\leq 10\%$ $A$ gets rewarded with $t_{fix} + t_{fix} \times 100\% = t$. 

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Only with a degree of $\geq 80\%$ of compliance of $A$ can be seen as entirely satisfactory and certain tiny flaws can be ignored and have no influence on the GCC.

**Stage 5**: $A$ is payed the remuneration according to the audit and $P$’s payoff can be calculated. $A$ will be rewarded for compliant behavior.

As stated in section 6.2, the CoC describes which issues (environmental, legal and health and safety issues) are of great importance. So there is no loophole to misapprehension to the norms and standards $A$ has to be compliant to.

6.4.1 Utilities in a CSR-setting

Given $P$’s Utility in Chapter 5 ($U_p = x - t$) his utility changes as follows in equation 6.6:

$$U_p = F(Aud) - t(Aud) - c_{Aud} \quad (6.9)$$

The variable $Aud$ as audit is introduced. The audit can either detect cheating or not:

$$Aud \in \{1,0\}$$

Now $P$’s utility equals, the direct utility of the performance in the audit, minus the remuneration (depending on the audit as well) minus the costs for auditing. Since $P$ is making use of third party auditing, he is contracting someone else to perform the audits. This leads to costs $c_{Aud}$.

The problem here is to quantify the utility of auditing for $P$. Since the downside of cheating cannot be evaluated beforehand (loss of reputation etc.)

Without auditing, the compliance of the CoC, is not verifiable and therefore the sustainability efforts of $P$ would not be credible. It is assumed that detecting cheating behavior minimizes $P$’s payoff. His payoff is smaller, because $x$ can only be sold for a cheaper price. In case of compliant behavior (no cheating was detected) he can sell $x$ with a higher price due to the fact that a positive audit signals sustainability.

$P$ aims to implements a CoC due to the fact that with being involved with CSR norms higher profit can be achieved. But for really achieving this goal, $P$ needs the credibility of really having implemented those norms, by implementing an auditing mechanism. So $P$’s direct utility of auditing is that his payoff increases because the output of the value increases and therefore his sales due selling sustainable clothes.
Hence we can say that $P$’s utility is now:

$$U_p = V = (x \cdot \omega_t) - t(Aud) - c_{Aud}$$  \hspace{1cm} (6.10)

Of course we have to define the remuneration based on the audit outcome. $t(Aud)$ can have three values:

$$t(Aud) = \{t + (t \cdot GCC)\}$$

**Agent’s Utility:**

$A$’s goal is to maximize his expected utility [Jost, 2001,p 47]. The expected utility depends positively on $t$ and negatively on his effort level $e$ [Jost, 2001,p 47].

$$U_a = u(t(Aud)) - g(e_i)$$  \hspace{1cm} (6.11)

$u(t)$ denotes $A$’s utility of the monetary compensation $t(Aud)$ dependent on the audit, while $g(e_i)$ is $A$’s disutility for exerting effort.

$A$ should be compliant by receiving a reward and thus an alignment of goals should be derived.

Further it is considered that $e$ can have two states $i$:

$$e \in \{e_{compliant}, e_{cheating}\}$$

It is assumed that the state $i$ of $e$ is not known to $P$. $P$ can only find out if the auditor (external) finds out about is or not. The chance of catching $A$ of cheating is 40:60; hence with a probability of 40% cheating behavior is detected and with a probability of 60 it will not be detected.

It is assumed, that the audit can take the following forms:

- $Aud_+ =$ no detection of non compliant behavior
- $Aud_- =$ detection of non – compliant behavior

For simplicity the following probabilites are assumed:

$$p(Aud_+) = 0,6$$  \hspace{1cm} (6.12)

$$p(Aud_-) = 0,4$$  \hspace{1cm} (6.13)
In case of a positive audit we have

Further the following probabilities are given:

\[
p(x_H | e_{cheating}) = 0,2 \quad (6.14)
\]

\[
1 - p(x_H | e_{cheating}) = p(x_L | e_{cheating}) = 0,8 \quad (6.15)
\]

\[
p(x_H | e_{compliant}) = 0,8 \quad (6.16)
\]

\[
1 - p(x_H | e_{compliant}) = p(x_L | e_{compliant}) = 0,2 \quad (6.17)
\]

So in case of cheating the output can be either high or low. The output is high with a probability of 20% and low with a probability of 80%. In case of complying the output is high with a probability of 80% and low with a probability of 20%.

Given the probabilities in 6.18-25 the following stochastic independencies can be written down:

\[
p\left(\text{Aud}_+ | x_H | e_{compliant}\right) = \frac{0,6 + 0,8}{0,8} = 0,6 \quad (6.18)
\]

\[
1 - p\left(\text{Aud}_+ | x_H | e_{compliant}\right) = p\left(\text{Aud}_- | x_H | e_{compliant}\right) = \frac{0,4 + 0,2}{0,2} = 0,4 \quad (6.19)
\]

\[
p\left(\text{Aud}_+ | x_L | e_{compliant}\right) = \frac{0,6 + 0,2}{0,2} = 0,6 \quad (6.20)
\]

\[
1 - p\left(\text{Aud}_+ | x_L | e_{compliant}\right) = p\left(\text{Aud}_- | x_L | e_{compliant}\right) = \frac{0,4 + 0,2}{0,2} = 0,4 \quad (6.21)
\]

\[
p\left(\text{Aud}_+ | x_H | e_{cheating}\right) = \frac{0,6 + 0,2}{0,2} = 0,6 \quad (6.22)
\]

\[
1 - p\left(\text{Aud}_+ | x_H | e_{cheating}\right) = p\left(\text{Aud}_- | x_H | e_{cheating}\right) = \frac{0,4 + 0,2}{0,2} = 0,4 \quad (6.23)
\]

\[
p\left(\text{Aud}_+ | x_L | e_{cheating}\right) = \frac{0,6 + 0,8}{0,8} = 0,6 \quad (6.24)
\]

\[
1 - p\left(\text{Aud}_+ | x_L | e_{cheating}\right) = p\left(\text{Aud}_- | x_L | e_{cheating}\right) = \frac{0,4 + 0,8}{0,8} = 0,4 \quad (6.25)
\]
Highlighted in 6.18-25 is the fact, that in case of cheating, the probability of not catching \( A \) of cheating is truly 60 \%. This indicates as well, as illustrated, that in case of compliant behavior the probability of a defective audit is by 40\%.

6.4.2 The Model

The following values are assumed:

- The agent can choose between two actions: \( e_{\text{compliant}} \) and \( e_{\text{cheating}} \)
  - Exerting effort is cost-intensive:
    
    \[
    g(e_{\text{compliant}}) = 40 \\
    g(e_{\text{cheating}}) = 25
    \]
  - There are two states of outcome: \( x \in \{x_L, x_H\} = \{5000, 15000\} \)
    
    \[
    x_H = 15000 \\
    x_H = 5000
    \]

- Auditing involves costs \( c_{\text{Aud}} = 500 \)
- According to section 6.2.1. \( A \) gets a \( GCC \) of 68 \% as a reward.
- Depending on the outcome, \( A \) gets \( t \in \{H, L\} \)

Now it is assumed that \( e_i \) is not observable. \( P \)'s maximization function with respect to CSR is now denoted as:

\[
\max_{e,t_i} \sum_{i \in \{\text{compliant,cheating}\}, j \in \{H,L\}} p(x_i|e_i) \cdot \\
[x_i - \left[p(\text{Aud}_+| (x_i|e_i)) \cdot (t_j + (t_j * GCC)) - p(\text{Aud}_-| (x_i|e_i))t_j - c_A]\right]
\]

\[
(IR_i) \quad \sum_{i \in \{\text{compliant,cheating}\}, j \in \{H,L\}} p(x_i|e_i)u(t_j) - g(e_i) \geq U_r = 0
\]

\[
(IC_i) \quad \sum_{i \in \{\text{compliant,cheating}\}, j \in \{H,L\}} p(x_i|e_i)u(t_i) - g(e_i) \geq \\
\sum_{i \in \{\text{compliant,cheating}\}, j \in \{H,L\}} p(x_i|e_k)u(t_i) - g(e_k)
\]

Where \( i = 1 = H, i = 2 = L \) and \( k = 3 - 1 \).

Depending on which effort level \( P \) wants to implement, the maximization problem fulfills each two ICs and IRs.
Implementation $e_{\text{compliant}}$:

By reinstituting the values in section 6.4.1. the following values are received:

$$
\begin{align*}
\max & \quad p(x_H|e_{\text{compliant}}) * \\
& x_H - [p (Aud_+(x_H|e_{\text{compliant}})) * (t_H + (t_H * GCC) - p (Aud_- (x_H|e_{\text{compliant}})) t_H - c_A)] + \\
& p(x_L|e_{\text{compliant}}) * \\
& x_L - [pp (Aud_+(x_L|e_{\text{compliant}})) * (t_L * (1 - GCC) - p(Aud_- e_{\text{compliant}}) t_L - c_A)]
\end{align*}
$$

Given the IR under first best (symmetric information), 5.15 now gives the following conclusion:

$$
\nu(t_i) = g(e_i) \rightarrow t_i^* = v^{-1}(g(e_i)) \rightarrow t_i^* = g(e_i)^2 \rightarrow \sqrt{t_i^*} = g(e_i) \quad (6.26)
$$

By insertion of the values of probabilities, equation (6.22) and the value of $g(e_i)$ the following constraint can be denoted:

$$(IR_{\text{compliant}}) \quad 0,8 \sqrt{t_H} + 0,2 \sqrt{t_L} - 40 \geq 0$$

$$(IC_{\text{compliant}}) \quad 0,8 \sqrt{t_H} + 0,2 \sqrt{t_L} - 40 \geq 0,2 \sqrt{t_H} + 0,8 \sqrt{t_L} - 25$$

$$
\begin{align*}
0,8 \sqrt{t_H} + 0,2 \sqrt{t_L} - 40 & \geq 0,2 \sqrt{t_H} + 0,8 \sqrt{t_L} - 25 \\
0,8 \sqrt{t_H} + 0,2 \sqrt{t_L} & \geq 0,2 \sqrt{t_H} + 0,8 \sqrt{t_L} + 15 \\
0,6 \sqrt{t_H} - 0,6 \sqrt{t_L} & \geq 15
\end{align*}
$$

$$
\begin{align*}
\sqrt{t_H} - \sqrt{t_L} & \geq 25 \\
\sqrt{t_H} & \geq 25 + \sqrt{t_L} \\
\sqrt{t_H} & = 25 + \sqrt{t_L}
\end{align*} \quad (6.27)
$$

Next step is to integrate formula 6.23 in $IR_1$ and receive $t_H$ and $t_L$:

$$
\begin{align*}
0,8 * (25 + \sqrt{t_L}) + 0,2 \sqrt{t_L} - 40 & \geq 0 \\
0,8 \sqrt{t_L} + 0,2 \sqrt{t_L} & \geq 20 \\
\sqrt{t_H} & = 45 \\
\sqrt{t_L} & = 20
\end{align*}
$$

$$
\begin{align*}
t_H & = 2025 \\
t_L & = 400
\end{align*}
$$
$P$’s payoff with $e_{\text{compliant}}$ now is:

$$V_{e_{\text{compliant}}} = p(x_H|e_{\text{compliant}}) \times [x_H - p(Aud_+(x_H|e_{\text{compliant}})) \times (t_H + (t_H \times GCC)) - p(Aud_-(x_H|e_{\text{compliant}})) \times (t_H - c_A)] + p(x_L|e_{\text{compliant}}) \times [x_L - p(Aud_+(x_L|e_{\text{compliant}})) \times (t_L + (t_H \times GCC)) - p(Aud_-(x_L|e_{\text{compliant}})) \times (t_L - c_A)]$$

By inserting all values pre-determined above the following expected payoff of $P$ can be calculated:

$$V_{e_{\text{compliant}}} = 0.8 \times [15000 - 0.6 \times (t_H + (t_H \times 0.68)) - 0.4 \times t_H - 500] + 0.2 \times [5000 - 0.6 \times (t_L + (t_H \times 0.68)) - 0.4 \times t_L - 500]$$

$$V_{e_{\text{compliant}}} = 0.8 \times [15000 - 0.6 \times (2025 + (2025 \times 0.68)) - 0.4 \times 2025 - 500] + 0.2 \times [5000 - 0.6 \times (400 + (400 \times 0.68)) - 0.4 \times 400 - 500]$$

$$V_{e_{\text{compliant}}} \approx 10106$$

$P$’s expected payoff now is 10016 assuming that $e_{\text{compliant}}$ is implemented, when the probability of audit is positive with 60% and the probability of audit is negative is 40%.

In case of $P$ wanting to implement $e_{\text{cheating}}$ $P$’s expected payoff is:

$$V_{e_{\text{cheating}}} = 0.2 \times [15000 - 0.6 \times (2025 + (2025 \times 0.68)) - 0.4 \times 2025 - 500] + 0.8 \times [5000 - 0.6 \times (400 + (400 \times 0.68)) - 0.4 \times 400 - 1500]$$

$$V_{e_{\text{cheating}}} \approx 5479$$

Next step is to evaluate the change in the expected payoff of $P$ when the principal’s payoff in when the audit probabilities are changing. Now the $p(Aud_+) = 0.6$ and $p(Aud_-) = 0.4$

Now it is assumed that the probabilities of a positive and negative audit are changing. The goal is to evaluate the influence on $P$’s expected payoff.

The following probabilities are assumed:

(1) $p(Aud_+) = 0.75$  (2) $p(Aud_+) = 0.5$  (3) $p(Aud_+) = 0.25$

$p(Aud_-) = 0.25$  $p(Aud_-) = 0.5$  $p(Aud_-) = 0.75$
ad (1):

\[ V_{compliant} = 0.8 \times [15000 - 0.75 \times (2025 + (2025 \times 0.68)) - 0.25 \times 2025 - 500] \\
+ 0.2 \times [5000 - 0.75 \times (400 + (400 \times 0.68)) - 0.25 \times 400 - 500] \]

\[ e_{compliant} \approx 9933 \]

As it can be seen, the value of P’s expected payoff has decreased (9933<10106) due to the fact that the probability of a negative audit has increased. Hence the error rate in means of cheating has increased.

The next two examples will show, that P’s expected payoff payoff is increasing with an increase of the probability of a negative audit. In case of a 50:50 audit situation, the expected payoff of P is 10222. Rising again the probability to \( p(Aud_{-}) = 0.75 \) we derive a payoff of 10511.

ad (2)

\[ V_{compliant} = 0.8 \times [15000 - 0.5 \times (2025 + (2025 \times 0.68)) - 0.5 \times 2025 - 500] \\
+ 0.2 \times [5000 - 0.5 \times (400 + (400 \times 0.68)) - 0.5 \times 400 - 500] \]

\[ e_{compliant} \approx 10222 \]

ad (3)

\[ V_{compliant} = 0.8 \times [15000 - 0.25 \times (2025 + (2025 \times 0.68)) - 0.75 \times 2025 - 500] \\
+ 0.2 \times [5000 - 0.25 \times (400 + (400 \times 0.68)) - 0.75 \times 400 - 500] \]

\[ e_{compliant} \approx 10511 \]

Implications:

Changing the probabilities regarding the form of the audits in direction of \( Aud_{-} \), it can be displayed that the expected payoff of P changes and thus increases. The reason is a decline of the error rate in means of cheating. This fact implies, that whereas the error rate in case of compliant behavior is increasing, this has no significant impact on the development of the expected payoff. Therefore it can be concluded, that reduction of the error rate of cheating is of great importance for a positive utility development.
In case of wanting to implement $e_{\text{compliant}}$, $P$ would not implement an auditing strategy, because his expected payoff is smaller than in the first best solution (will be derived in the next section).

6.5. **First best optimal contract – symmetric information**

If the fact, that non-compliance can be detected with a certain probability is neglected and it is assumed that with monitoring and third party auditing the effort level is observable, this thesis argues, that this situation equals a PAM-problem with symmetric information and therefore the first-best solution can be reached.

As described above, the PAM with respect to CSR is based on an auditing mechanism. Hence the variable $A$, for Audit will be introduced:

$$A = [0; 1]$$

It is assumed that the Audit is dependent on the effort level of $A$. Therefore it can be said, that the higher the effort the better the Audit result:

$$A = e$$

The result $x$ of the task can have to states of nature:

$$x = [0; 1]$$

Further the notation as introduced in Chapter 5 is valid for the agents transfer $t$ and the effort level $e$.

**Principal’s Utility:**

It is assumed that $P$ is risk-neutral.

$$U_p = F(A,x) - t(A) \quad (6.28)$$

**Agent’s Utility:**

$$U_A = u[t(A)] - g(e) \quad (6.29)$$

$g(e)$ signifies the costs for exerting effort $e$ and given that $t(A) = A$ and $A = e$ the following assumption can be made:

$$g(e) = e^2 \quad (6.30)$$
Hence the following equation can be denoted:

\[ \sqrt{A} - e^2 \] (6.31)

Given \( \sqrt{A} - e^2 \) the agent would not exert and therefore \( e \neq 1 \) but it is now further assumed that \( A = e \) and hence equation (6.31) changes as follows:

\[ \sqrt{e} - e^2 \] (6.32)

But in case of assuming that \( v[t(A)] = 2\sqrt{A} \) and \( C(e) = 0.5 \cdot e^2 \) it would lead to an effort level \( e = 1 \), since it will maximize A’s utility.

Risk neutral function example:

\[ F(A, x) = 2 \cdot A \cdot x \] (6.33)

Linear payoff:

\[ t(A) = A \] (6.34)

\[ U_p = 2 \cdot A \cdot x - A \] (6.35)

\[ U_p \ max = 1 \ (if \ A = 1; \ x = 1) \] (6.36)

\[ U_a = u[t(A)] - g(e) \] (6.37)

Given equation (6.37) we insert equation (6.34) and receive the following agent’s utility:

\[ U_a = v(A) - g(e) \] (6.38)

Convex effort cost function:

\[ g(e) = 0.5e^2 \] (6.39)

Concave payoff utility function:

\[ v(A) = 2 \cdot \sqrt{A} \] (6.40)

Bringing equation (6.39) and (6.40) in equation (6.38) the following equation can be received:

\[ U_a = 2 \cdot \sqrt{A} - 0.5e^2 \] (6.41)
If Audits reveal full information it is assumed that $A = e$.

Therefore the variable $A$ is substituted by the effort level $e$ and equation (6.41) changes as follows:

$$U_a = 2 \cdot \sqrt{e} - 0.5e^2$$  \hspace{1cm} (6.42)

$$\frac{\partial U_a}{\partial e} = 0$$  \hspace{1cm} (6.43)

Next step is to differentiate with respect to the effort level:

$$\frac{2}{2} \cdot \frac{1}{\sqrt{e}} - e = 0$$  \hspace{1cm} (6.44)

$$e = \frac{1}{\sqrt{e}}$$  \hspace{1cm} (6.45)

$$\sqrt{e} = 1$$  \hspace{1cm} (6.46)

$$e = 1$$  \hspace{1cm} (6.47)

6.5.1 First best solution

In case of symmetric information it is assumed that $e_i$ is observable. Therefore it is assumed that auditing is not necessary anymore, as highlighted before. In Chapter 5 the thesis showed that first-best contracts are dependent on the observable $e_i$ and not on $x_i$.

$$\max_{e,t_i} \sum \{e (compliant, cheating) \mid j \in (H,L) \} \quad p(x_i | e_i) \cdot \left[ x_i - \left[ p(Aud_{+} | (x_i | e_i)) \cdot (t_j + (t_j * GCC)) - p(Aud_{-} | (x_i | e_i))t_j - c_A \right] \right]$$

Given, that auditing in symmetric information is not necessary, the following maximization function is stated:

$$\max_{t_i(e)} \sum_{i=H,L} p(x_i | e_i) \cdot x_i - t_i$$

$$(IR_i) \quad v(t_i) - g(e_i) \geq U_r = 0$$

$$v(t_i) = g(e_i) \rightarrow t_i^* = v^{-1}(g(e_i)) \rightarrow t_i^* = g(e_i)^2 \rightarrow \sqrt{t_i^*} = g(e_i)$$

When the values above get inserted, the following lottery (P’s profit) can be displayed according to the Neumann-Morgenstern theorem:

$$\sum_{i=1}^{n} p_i \cdot u(x_i)$$  \hspace{1cm} (6.48)
\[ e_i = \begin{cases} e_H \rightarrow L_1 = (15000:0.8; 5000:0.2) \rightarrow E[L_1] = 15000 \times 0.8 + 5000 \times 0.2 = 13000 \\ e_L \rightarrow L_2 = (15000:0.2; 2000:0.8) \rightarrow E[L_2] = 15000 \times 0.2 + 5000 \times 0.8 = 7000 \end{cases} \]

Hence for \( t_i^* = g(e_i)^2 \):

1. \( e_H \):
   \[ t_H^* = 40 \times 40 = 1600 \]
   P’s profit:
   \[ E[L_1] - t_H^* = 8400 - 1600 = 11400 \]

2. \( e_H \):
   \[ t_L^* = 25 \times 25 = 625 \]
   P’s profit:
   \[ E[L_2] - t_L^* = 7000 - 625 = 6375 \]

Here it is obvious that P will choose the implementation of \( e_H \), when A’s action is observable. Since P’s payoff with \( e_H > e_L = 11400 > 6375 \).

Given the solution in this example P’s expected payoff with implementing \( e_{cheating} \) in the symmetric information setting and compare it to the expected payoff in the asymmetric setting, he is definitely better of choosing to not implement an audit mechanism.

Further it can be concluded that in case of using an audit mechanism, the expected payoff in symmetric information is way higher (in each case of probability of positive/negative auditing). Given \( p(Aud_+) = 60\% \) and \( p(Aud_-) = 40\% \) and the expected payoffs in asymmetric and symmetric information, we receive a \( \Delta payoff = 1294 \), due to the fact, that no rewarding system was implemented as well as no measures for auditing (\( c_A \)).
7. CONCLUSION

“Since the definition of codes of conduct is written in a blurry and indefinite way, safeguarding mechanisms and auditing are essential to give incentives to compliant behavior based on a CoC. The behavior of suppliers and sub-contractors (first and second tier) is sadly not observable in asymmetric information.” [Bachmann/Ivansits, 2011]

“[This thesis] used the principal-agent model to analyze the conflict of interests between different actors in a global supply chain and assigned Bestseller, [H&M and the Inditex Group] the role of the initiator (principal) and the suppliers the role of the agents. Under this framework it was analyzed how the three leading fashion companies are making use of safeguard mechanisms in order to circumvent problems occurring in a principal-agent relationship. Further the classical safeguard mechanisms based on Koch (1995) and Andersen and Pedersen (2006) were illustrated and the importance of transparency as an additional safeguard mechanism was outlined.” [Bachmann/Ivansits, 2011]

The following questions were addressed and it was attempted to give answers:

i. Is there a relationship between the integration of the concepts of sustainability and economic success?

ii. What kind of incentives do suppliers need to be compliant?

iii. How do safeguard-mechanisms get implemented and managed in specific multinational fashion corporations?

iv. Is there a perfect contract to incentivize the suppliers to be compliant to the company with the purchase power?

In Chapter 3 the topic of motivations to engage into CSR was discussed. It illustrated that an increasing number of scientific studies showed companies clearly identifiable benefits in implementing CSR measures such as SSC and COC [Van Yperen, 2006]. Hence, there is a balance between promoting higher reputation with CSR measures and profit maximization. “This can lead to higher respect for their company amongst their shareholders, which can result in higher sales, enhance employee loyalty and attract better personnel to the firm. Further, CSR activities focusing on sustainability issues may lower costs and improve efficiencies as well.“ [Robins, 2011]
Chapter 3 discussed the question of how to implement a CoC to enhance compliant behavior. Therefore the safeguard mechanisms were introduced, divided in direct safeguard mechanisms and indirect safeguard mechanisms [Pedersen/Andersen, 2006]. They either give the suppliers directly an incentive to be compliant by observation or can align the interests of the supplier with the ones of the company [Pedersen/Andersen, 2006]. In addition another safeguard mechanism - Transparency - was developed. It is argued that a high degree of transparency, first in the relationship between principal/buyer and agent/supplier and second in the relationship between buyer and its stakeholders, can essentially help to safeguard the CoC by lowering informational asymmetries between the parties. On the other hand full transparency can also be harmful for a company. Disclosing information may lead to a strategic disadvantage of the company.

The case study (Chapter 4) aims to answer the question how safeguard mechanisms work in practice. With an explorative analysis approach, the reports and homepages of Bestseller, Inditex Group and H&M were analyzed.

“One of the findings was that Bestseller focuses on safeguards like goal coherence and trust while neglecting other safeguard mechanism like transparency or reputation effects” [Bachmann/Ivansits, 2011], while H&M and Bestseller are making use of all safeguard mechanisms but direct sanctions. “The companies engage in long-term relationships and in a strong dialog with its suppliers, which facilitate the development of trust and goal coherence. To a limited extend Bestseller makes use of direct sanctions as an effective safeguard. The engagement in long-term relationships makes this instrument less attractive.” [Bachmann/Ivansits, 2011]

In conclusion some might say, that all companies are engaged in CSR norms, but the analysis lacks credibility due to the fact that the data is only based on secondary literature. “Another question, which has to be taken into consideration, is if suppliers have the resources to fulfill Code of Conduct requirements. Considerable initial investments on behalf of the initiating company might be necessary. Further research has to be conducted to analyze if this strategies is in line with the initiating company’s interests. Higher switching costs and increased sunk costs of mutual investments might weaken the bargaining position of the initiating company compared to its suppliers.” [Bachmann/Ivansits, 2011]
Further the thesis aimed to model an optimal contract in means of CSR. First probabilities for a positive and negative audit are assumed and by attempting to implement these probabilities in the principal’s maximization function, the principals expected payoff was calculated. The interpretation of the outcome is, that with auditing the payoff is of course smaller, but it is not the only aim to increase the payoff but to enhance CSR-credibility, which leads to higher reputation, thus to higher sales. To show, that the expected payoff for the principal change, the probabilities of a positive/negative audit were changed and it showed, that the payoff is increasing the higher the possibility of a negative audit. Changing the probabilities regarding the form of the audits in direction of $\text{Aud}_+$, it can be displayed that the expected payoff of $P$ changes and thus increases. The reason is a decline of the error rate in means of cheating. This fact implies that whereas the error rate in case of compliant behavior is increasing, this has no significant impact on the development of the expected payoff. Therefore it can be concluded, that reduction of the error rate of cheating is of great importance for a positive utility development.

To give the agents incentives to be compliant some of the safeguard mechanisms were combined in one measure Goal Congruence Correction Factor – in order to establish a reward system for compliant behavior. It argues, that in case of compliance, the agent is rated according a traffic light system, based on the Goal Congruence Correction factor. This factor has an impact on the risk premium. Of course therefore the fix wage has to be very low.

Generally, there is no such thing as an “optimal contract” with CSR and the calculations in Chapter 6 attempt to implement a CSR focus on a principal agent model, but the verification of the model is questionable.
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10. APPENDIX

10.1. Abstract

**Purpose** – This thesis seeks to discuss the topic of CSR in the supply chain of fashion companies using the principal agent theory to explain the optimal contract to incentivize suppliers. Further research will show how three fashion firms are dealing with their ethical standards in practice and what kind of incentives really works in the business world. Additionally a model with respect to CSR will be introduced.

**Methodology** – The paper introduces different theories and focuses on the principal-agent theory. First safeguard mechanisms will be introduced and then a case study based on three big fashion companies and their incentive and reporting systems are introduced as well. Further a basic principal – agent model will be modeled and based on the model changed for the situation with CSR.

**Findings** – Generally, there is no such thing as an “optimal contract” with CSR although an optimal contract based on the situation can be generated and put in practice. Further it can be said, that there is not a benchmark for perfect CSR practice. There is always a notion of failure included.

**Research Limitations** - The thesis focuses on CSR practices in specific company’s supply chain. Further it only uses second literature and does not have real internal company information. Focus is on the principals (“social watchdog”) not on the suppliers (“agents”).

**Practical Implications** – The incentive safeguard mechanisms adopted by the three companies can be of great use and can serve as an inspiration for other companies. The contract might be adapted in for the company’s purposes and therefore better contracting in means of CSR can be generated.
10.2. Abstrakt


**Anwendungsgrenzen** – Diese Arbeit konzentriert sich auf die CSR Praktiken in der Mode-Wertschöpfungskette. Die „safeguard mechanisms“ werden auf der Grundlage von Sekundär-Literatur (Internet-Recherche und Interview) analysiert. Der tatsächliche
Einblick in das Firmengeschehen fehlt somit. und tatsächliche verifizierbare Aussagen können nicht getätigt werden.

**Praktische Implikationen** – Der GCC kann beliebig von Modefirmen angewendet werden. Mit Hilfe dieses Faktors in Verbindung mit dem Ampelsystem lässt sich ein sehr gutes Belohnungssystem ermitteln. Die Arbeit zeigt auf, welche Faktoren für eine bestmögliche Anreizgestaltung benötigt werden.
10.3. Conventions

10.3.1 Universal Declaration on Human Rights (UDHR)

The Universal Declaration on Human Rights25 was adopted by the United Nations in 1948 and is the most universally recognized definition of human rights. It covers civil and political rights, as well as economic, social and cultural rights. Most CSR policies and standards are based on the UDHR. Together with two other Covenants from 1996, it is called the International Bill of Human Rights. Those covenants are: International Covenant on Civil and Political Rights (ICCPR) and the International Covenant on Economic, Social and Cultural Rights (ICESCR).

10.3.2 UN Convention of the Rights of the Child (CRC)

The Convention on the Rights of the Child (www.unicef.org/crc/crc.htm), adopted in 1989, is a universally agreed set of non-negotiable standards and obligations. It spells out the basic human rights that children have everywhere: the right to survival; to develop to the fullest; to protection from harmful influences, abuse and exploitation; and to participate fully in family, cultural and social life. Every country in the world, except for two countries, has ratified it: USA and Somalia, which have signaled their intention to ratify.

10.3.3 ILO Conventions

The International Labor Organisation26 is a tripartite UN organization representing governments, businesses and workers and has set up a legal and policy framework for labor issues. The ILO has issued almost 200 conventions on working conditions. Eight of these specify the four fundamental labor rights:

• Freedom of association and the right to collective bargaining;
• A ban on forced labor;

Van Yperen, 2006
• A ban on child labor;
• A ban on discrimination in the workplace and in professions.

The ILO conventions focus in particular on government’s responsibilities with respect to labor rights. The Tripartite declaration of Principles Concerning Multinational Enterprises and Social Policy extends the ILO Conventions, listing corporate responsibility with regard to labor issues and also including a number of additional labor standards falling under the specific responsibility of corporations.
Project

How BESTSELLER safeguards its global supply chain - an evaluation of BESTSELLER's way of dealing with CSR in their supply chain

for the course: CM_Ø64 - Corporate Social Responsibility in Global Supply Chains

Teacher:

Esben R.G. Pedersen

Handed in by:

Johannes Bachmann
Sarah Ivansits
1. Introduction

This paper will analyse BESTSELLER’s CSR-practices within its global supply chain. It commences with a short introduction of the company and explains how BESTSELLER deals with CSR topics within the firm. Furthermore the paper introduces the Principle-Agent-Problem in context to CSR and outlines an approach of how incentivise suppliers in BESTSELLER’s supply chain, to be compliant with BESTSELLER’s code of conduct. Additionally it will be explained the functionality of different safeguard mechanisms based on Koch (1995) and extend the five safeguard mechanisms with one additional dimension. Furthermore analyse is provided on how BESTSELLER is making use of safeguard measures in their current CSR-strategy and it is shown that BESTSELLER works with a limited focus on certain safeguard mechanisms while neglect the use of other possible safeguard mechanisms. In conclusion the paper suggests how to optimise BESTSELLER’s CSR-strategy in this context.

2. The case of BESTSELLER

BESTSELLER is a Danish textile industry company, founded in 1975 by Merete Bech Povlsen and Troels Holch Povlsen in Ringkøbing. It started out as a small company offering women’s fashion and has now established itself as significant company with a multi-brand strategy. Their brands entail; JACK & JONES, NAME IT, MAMALICIOUS, OBJECT COLLECTOR’S ITEM, ONLY, OUTFITTERS NATION, PIECES, SELECTED, VERO MODA and VILA CLOTHES. It is still a 100% family owned company. The products BESTSELLER offers differ now from women wear to men wear, clothes for children and teenager as well as accessories, sales encompass international scope - BESTSELLER exports its products on 46 markets in Europe, the Middle East, Asia and Canada through 2,520 chain stores, of which 308 are situated in Denmark, and 12,000 external multi-brand stores. Therefore it can be seen, that BESTSELLER is the leading textile industry company in Denmark as well one of the leading textile firms in Europe.

As Troels Holch Povlsen states himself “Besteller’s good competitors are not to be found in Denmark” (Børsen, 2002) referring to the biggest textile industry companies such as Inditex Group (ZARA, BERSHKA, Stradivarius, Pull & Bear etc.), American
Gap Inc. and Hennes & Mauritz. All of the before named corporations act worldwide and target the same customers as BESTSELLER.

Seen from a global supply chain perspective, the company has chosen to produce their garments and accessories in factories in India, Bangladesh, Turkey, Italy and especially in China. It is an established fact that Asian countries compliance to ethical standards is not universally given. Therefore BESTSELLER tends to engage in long term relationships with its suppliers to avoid problems concerning their CSR – standards because one of BESTSELLER’s biggest priorities is their CSR-policy.

3. CSR of Bestseller

CSR is the abbreviation of Corporate Social Responsibility and it simply means that an organizations obligation to maximize its positive impacts and minimize its negative impacts on society. Bestseller on the one hand is producing its garments and accessories in developing countries (China, India…) to decrease production costs. However whilst this beneficial to the company, it is also shown it is trying to maximize its positive impact by putting pressure on their suppliers and the government of the host countries to improve the standards and working conditions for their staff.

In the past Bestseller has recognized that it is very important to engage in CSR activities. As well as this, the importance of responsible behaviour by their suppliers, when it comes to CSR practices, is pivotal. The challenge is to strike an equitable and practicable balance between the commercial imperative of continuing to do business and ethical demands. (Investments for Development, p.2) Even the most diligent companies with the best monitoring practices and contractual arrangements will sometimes find themselves associated with suppliers violating CSR issues.

BESTSELLER has written down their first Code of Conduct in 2002, and since then they have come far with their work concerning corporate social responsibility and sustainability (Interview with Anja Bremholm CSR-Bestseller, March 2011)

For example BESTSELLER is engaged in “Responsible Production” which means that the

45 see appendix , Questionnaire with Anja Bremholm
company wants to guarantee that the suppliers are compliant with the CSR-rules of BESTSELLER. A central issue is to convey its suppliers to understand the importance of good CSR-strategies for the mutual success. Furthermore, BESTSELLER is engaging in a stakeholder dialog and engages in a long term relationship with its suppliers. Besides its core competences, the company is involved with CSR-measures like “Responsible Development” (establishment of a non-profit charitable organization which works with the poorest levels of society in India and China) and “BESTSELLER – Sponsorship” (ex. partnership of the Olympic games).

In 2011 BESTSELLER implemented a training program for their designers and buyers that aims to teach them how their everyday decisions may have an influence on their suppliers’ ability to follow their Code of Conduct (Interview with Anja Bremholm CSR-Bestseller, March 2011).

Furthermore BESTSELLER has participated in the establishment of Danish Ethical Trading Initiative (DIEH) which is a partnership between the business world, trade unions and NGO’s. The initiative was found in February 2008 and it is the first Danish multi-stakeholder initiative that brings together trade unions, business associations, non-governmental organizations (NGOs) and companies to promote ethical trade and responsible supply chain management among Danish companies.

4. Code of Conduct

In an increasingly globalized world companies are making a higher effort to implement CSR Strategies in their supply chains. Consumers, the media and international watchdogs are increasing the pressure on companies to focus on topics like working conditions, the abuse of union rights, child labour or pollution. This is especially true for companies producing within global supply chains and utilizing strategic comparative advantage by producing in developing countries. Many multinational corporations responded to the pressure by introducing certain requirements, codes of conducts that intend to increase the social and environmental performance of the company. The branded clothing sector has already a wide adoption of codes of conducts and shows a good performance in the Implementation of CSR Strategies (Roberts, 2003). In the case of BESTSELLER the codes of conduct describe specific standards and requirements which have to be fulfilled by cooperating companies in order to be accepted as a supplier. The code of Conduct of
BESTSELLER describes in detail the companies’ ethics and standards. BESTSELLER demands that all participants in the supply chain are compliant to these standards stated in the code of conduct. Subcontractors are also incorporated into these standards.

BESTSELLER’s code of conduct consists of specific points such as Human Rights and Labour Rights (child labour; no children under 15, minimum wage), Health and Safety (protection from chemical exposure, fire safety), Environmental Protection (chemical restrictions, water standards) and Animal Welfare (against animal testing and the gain of leather or feather on alive animals).

A code of conduct is a voluntary statement of a company, consisting of internal guidelines, standard principles to improve their sustainability. Since there is no national law to force companies to act responsibly, the code of conduct is not enforceable. So the company is responsible for the compliance of the code of conduct in means of their own company and the other participants in the supply chain. This underlines the importance of safeguarding and monitoring mechanisms which will be discussed in chapter 5 and 7.

5. Auditing and Monitoring BESTSELLER’s Code of Conduct

BESTSELLER seeks sustainability in their supply chain and since they have strict guidelines written down in their code of conduct the aim is for total compliance within the supply chain. To make sure that BESTSELLER’s suppliers and their sub-suppliers meet the laws and requirements auditing and monitoring is necessary.

Therefore an “Audit Program” with audits every two years as well as a traffic light-system to rate suppliers, were implemented. The traffic light system keeps track of the developments made by each individual factory.

The results of an additional, independent third-party audit are entered on the online audit form in the Supplier Portal which includes all suppliers BESTSELLER is working with. A rating based on the results of the audit will automatically be generated in the system and given to the factory. Red factories will not be accepted for production.
In case of non-compliance the consequences vary according to the specific circumstances, which will be reviewed on a case-by-case basis (BESTSELLER Supplier Guide, p.12). Either the problems can be prevented and there is a perceived willingness to improve. In case of further non-compliance the long-term relationship will be terminated.

Dishonesty during the audit (for example, showing fake documentation) is taken very seriously and factories that cannot show an accurate account of the situation during the Bestseller audit will automatically be rated red. Factories that display a thorough and reliable account will not face punitive action, but will be expected to work on improving the situation in collaboration with Bestseller (BESTSELLER Supplier Guide, p. 12).

6. Principle – Agent Theory

Costs and benefits of acting in a socially and environmentally responsible way might be unevenly (unequally) distributed over the supply chain. In the branded cloth industry the additional benefits of increased reputation (due to the compliance with CSR Strategies) favour the owners of the brands. Suppliers often have to bear the costs of the implementation of social and environmental strategies without directly profiting from it. This relationship can be analyzed using the classical principal agent theory. The characteristics of the principle – agent problem are characterized by imperfect and asymmetric information. The problem all principals confront in principal – agent situations is how to align the interests of the agent with those of the principal. The problem in this relationship is opportunistic behaviour, because the goals of the agent can often differ from those of the agent, and therefore the agent may act opportunistically. In a standard principal agent model (shareholder-manager relationship) a strict contract is

<table>
<thead>
<tr>
<th>Rating</th>
<th>General description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Green</td>
<td>Factory is working according to Bestseller’s Code of Conduct and has systems in place to ensure that it will be able to maintain a high standard. Factory demonstrates a number of best practices. Factory is not perfect and should always be working to improve further on sustainability issues and maintain a high standard.</td>
</tr>
<tr>
<td>Yellow</td>
<td>Minor issues are found and highlighted as needing improvement. Factory is making continuous progress and is transparent and open.</td>
</tr>
<tr>
<td>Orange</td>
<td>Some “serious” issues and/or a number of minor issues are found, but the factory is transparent and open to work on improvements.</td>
</tr>
<tr>
<td>Red</td>
<td>Factory is non-compliant to the Code of Conduct. Critical issues are found which automatically result in a red rating. If factory is not transparent or dishonest and does not allow auditor full access to the site and true records, factory will automatically receive a red rating.</td>
</tr>
<tr>
<td>Black</td>
<td>Factory is far below standard required in production sites. Black rated factories can never be used to manufacture Bestseller products. Factory may be black-listed for a number of reasons, including dishonesty and corruption.</td>
</tr>
</tbody>
</table>

Figure: Rating of BESTSELLERS’s suppliers (BESTSELLER Supplier Guide, p. 9)
formulated in order to diminish asymmetric information and opportunistic behaviour. Since the CoC is not an enforceable contract, the provision of appropriate incentives and monitoring measures becomes essential. Non compliant behaviour on behalf of the suppliers lead to extensive costs and a considerable loss of reputation.

The principal (the owner of the brand) has an interest in introducing and enforcing CSR strategies throughout the supply chain, while the agent who does not profit directly from this, has little interest in doing so. In order to avoid opportunism, it is necessary to provide the agent with incentives to act in accordance with the principal’s interest. In short this can be done either by monitoring behaviour or rewarding outcomes.

Monitoring can be seen as a mechanism used by the principal to obtain information about the actions of the agent, whereas rewards are outcome-based, financial incentives. As long as there is no divergence between the interest of principle and agent, the so – called “agency costs” will not occur.

Speaking of BESTSELLER, the company is the so-called initiator of the CSR-policy and wants its suppliers to be compliant to their code of conduct. So BESTSELLER is the principle and the other participants in the supply chain are the so-called agents. Moral hazard (hidden action) arises when the agent’s action, or the outcome of that action, is only imperfectly observable to the principal after a contract is signed. In our example BESTSELLER engages in a contract with a supplier who ex-post uses production factors of non-compliant sub-suppliers. Adverse selection (hidden information) can arise when the agent has some private information, prior to entering into relations with the principal. It is e.g. suppliers of BESTSELLER trying to hide non-compliant behaviour before signing the contract.

7. Safeguarding mechanisms in the Supply Chain

In order to overcome the classical Principal Agent Problem during the integration and maintenance of CSR strategies, certain safeguard mechanisms can assure compliance with the code of conducts throughout the supply chain. According to Koch (1995) and Pedersen and Andersen (2006) we distinguish five different safeguard mechanisms: reputation effects, trust, goal congruence, third party interventions and direct sanctions. These concepts partly overlap and have blurred boundaries. This paper will explain how these different Safeguard mechanisms work and investigate how BESTSELLER is
making use of them. Furthermore the analysis is extended using the five safeguard mechanisms approach to another dimension - transparency.

7.1. Direct Sanctions

Provided that a company has a sufficient level of bargaining power in the supply chain the mechanism of direct sanction seems to be straightforward. In the case of noncompliance of a supplier a company can directly punish them. Direct sanctions might manifest themselves in different forms. The buyer can withhold payments until a certain improvement is undertaken or simply decrease the quantity of orders. The fastest and most ultimate sanction is certainly to break off the relationship with the supplier (Pedersen and Andersen, 2006). Direct sanctions can be a very effective safeguard mechanism, however the reciprocal character of the buyer-supplier relationship makes this mechanism ineffective. When a company imposes direct sanctions on a supplier it has to calculate the indirect costs for the company itself. For instance, the cost of breaking the long-term relationship with the supplier or the cost of lost investments in e.g. improving the working conditions of the supplier. When the costs outweigh the benefits from the long-term cooperation, the direct sanctions are rather unrealistic. Furthermore the implementation of direct sanction can be difficult since non-compliance with the CoC is not always visible.

The same is true for BESTSELLER. It recognizes, that while suppliers must live up to the Code of Conduct, there are no guarantees that they actually do so. Instead, Bestseller values suppliers who make an effort and show willingness to improve. BESTSELLER’s perspective is that it is better to keep collaborating with such non-complying factories and in this way contribute to the improvement of their working conditions (Responsible Production – Bestseller). Consequently BESTSELLER is making use of direct sanctions less frequently and only in severe cases of non-compliance with the code of conducts. Bestseller's supplier-rating system is the main instrument that enables the company to react appropriately to non-compliance (presented in chapter 5). For example, firms that act dishonestly during an audit (showing fake documentation) will automatically be rated red. In less severe cases of non-compliance, BESTSELLER asks their suppliers to design a development plan on how to improve their shortcomings and asks them to report back regularly (Supplier Guideline - Bestseller 1-22 p. 12). In summary, BESTSELLER is making use of direct sanctions, as a powerful tool to discipline suppliers, less frequently.
As described below, it puts more emphasis on other mechanisms like goal congruence or trust.

7.2. Third Party intervention

The legal system, industry organisations, external auditors, the public and NGO’s are examples for third parties who can play an important role to safeguard the COC of a company. The most important institution might be the legal system of the states. If a supplier is not acting according to the national law, he can be punished and forced to alter its behaviour. However, since the COC often go beyond national law requirements, legal institutions can assure compliance only to a limited extent. Weak institutional structure and unclear formulated COC make the enforcement of the codes difficult. Therefore, it is relevant to consider additional third parties that can safeguard the companies COC. External auditors for example can help to increase the credibility of a companies CSR strategy. Certification agencies can help to screen the market, reduce the search costs and assure that a supplier is in compliance with the requirements of a company. The public, NGO’s and watchdogs can exert considerable pressure on a company and force them to engage in a sustainable strategy.

BESTSELLER recently changed its auditing and monitoring strategy. For many years the company conducted only internal auditing. In order to increase the companies credibility BESTSELLER outsourced the auditing department partly (Bremholm, 2011). The company tries to utilize specific resources and competencies external auditors have command of and conducts now internal and external auditing.

7.3. Goal Congruence

In order to overcome the principal agent problem, measures to increase goal congruence are crucial to lower the risk of moral hazard. Opportunism is only likely to occur, if there is a conflict of interest between the principal and the agent. It is not enough if the initiating firm has a strong interest in implementing CSR-Strategies; it also has to convince its suppliers, that such a behaviour is preferable. Goal congruence is especially important in global supply chains, where non-compliance is often invisible and monitoring is costly. It can be achieved in many different ways. The initiating company can compensate its suppliers for the costs social and environmental enhancing strategies.
may cause. The buyer can reward the supplier for desired behaviour; buyer and supplier can undertake joint investments and the buyer can involve the supplier in the development and integration of the Code of Conduct (Pedersen and Andersen, 2006).

BESTSELLER is trying to increase the goal congruence of its suppliers in many ways and engages in a bottom-up approach in implementing its Code of Conduct. BESTSELLER requires their suppliers to develop their own strategy in how to implement certain requirements and improve working or environmental conditions. Particularly, suppliers should perform their own risk assessment of all facilities to identify areas in need of improvement, and perform periodic self-evaluation checks on own and subcontractors' facilities. BESTSELLER is supporting the suppliers and offers organized workshops and consulting to improve possible shortcomings (Codes of Conduct – BESTSELLER p.3).

The engagement in long-term relationships facilitates this cooperation. Furthermore, BESTSELLER runs an IT-based system, the Supplier-Portal to enable the communication between the company and its suppliers. Here they are also able to view the current status of their factories and the developments that are needed according to the last audit that was done (Supplier Guideline - Bestseller 1-22 p. 12). This strong emphasis on internal communication proves the companies will engage in a dialog with its suppliers and achieve goal coherence. Another way of how BESTSELLER tries to facilitate enhanced goal coherence is by limiting the number of suppliers and sub-suppliers. With a limited number of actors coherence is easier to achieve.

7.4. Trust

Asymmetric information between principal and agent might lead to moral hazard and opportunistic behaviour as described above. Engaging in long-term relationships provides both sides with additional information about each other and helps to assess the risk of hidden action more accurately. A long term relationship can be understood as an ongoing screening process of the contractual partner. When a supplier was behaving in a cooperative and productive manner in the past, the buyer might expect him to follow the same behaviour in the future (Pedersen and Andersen, 2006). Thus, a relationship characterized by trust can emerge between the parties. As a consequence controlling and monitoring effort can be reduced and translate to considerable cost savings for the buyer.

When implementing and safeguarding its global supply chain BESTSELLER puts a strong emphasis on deep and long-term relationships with it suppliers. BESTSELLER
understands that mutual trust in the buyer-supplier relationship can be an essential safeguarding mechanism:

“We have worked with many of our biggest suppliers for a very long time, and it is our belief that close long-term relationships are preferable in order to ensure the best COC results. Mutual trust and understanding are the main pillars of a good relationship, and that is not established over night. It is our impression that the longer we have worked with a supplier, the better he understands the motives behind our COC. (Interview – BESTSELLER)”.

The way BESTSELLER is integrating CSR-Strategies in its supply chain requires a high degree of self reliance and autonomous implementation on part of their suppliers. In the case of non-compliance with the COC the company conducts a case-by-case analysis, the consequences depending on the type of relationship, level of trust and the severity of the instance. BESTSELLER engages in a dialog with its suppliers in order to develop a strategy to improve shortcomings but at the time the supplier is still responsible for successful implementation. These trust-based follow up activities are complemented with certain control mechanisms, like auditing. The intention to lower the number of suppliers and sub-suppliers in its supply chain intends to facilitate strong relationships characterized by mutual trust.

7.5. Reputation effects

An improvement of the external perception and reputation of a company can be a central determinant for why a company is engaging in CSR. Communicating benefits of improved reputation to its suppliers can be an important task for a company in order to safeguard its CSR-Strategies. The supplier should understand that reputation can be seen as a resource to create a strategic advantage and generate higher future income (Roberts and Dowling, 1997; Koch, 1995). When suppliers are convinced, that the integration of sound CSR-Measures can be rewarding and is in line with their interests, a large part of the conflict of interests between buyer and supplier disappears.

It is important to analyze the power-structures in the supply chain relay on reputation as a safeguard mechanism (Pedersen and Andersen, 2006). First, the brand owner will be the main beneficiary of an improvement in the brand reputation (Roberts, 2003). A good
reputation enhances the value of all products and services a company sells. The question remains, if the brand-owner is able to pass on some of these benefits down the supply chain and convince the suppliers to act as a reliable partner. An upstream concentration of bargaining power will make compliance with brand owner requirements more likely. Traditionally, the branded clothing sector has a wide adoption of COC concerning working conditions, labour rights and environmental problems (Roberts, 2003). Brand-owners usually face a large number of competing suppliers, willing to produce the goods the brand-owner needs. In such a setting the brand-owner has a good bargaining position to require the implementation of COC in their supply chain. On the other hand, if the brand owner is engaging in long term-relationships, compliance might become the preferable strategy for the suppliers. Higher future benefits of being a reliable partner might outweigh short term cost-savings through noncompliance. Thus, to relay on reputation effects as a safeguard mechanism, analysis of the distribution of bargaining power in the supply chain is required and a closer look at the relationship between buyers and suppliers has to be conducted.

BESTSELLER is making use of reputation effects as a safeguard mechanism. The bottom up integration strategy of the COC, as described above, shows BESTSELLER’s dedication for a strong dialog and long term relationships. The company aims to establish long-term and close relationships with its suppliers (Supplier Guideline - Bestseller 1-22 p. 10). Putting an emphasis on intensive dialog enables BESTSELLER to convince the suppliers that compliance with the COC and therefore acting as a reliable partner is beneficial to them. Future long term benefits can outweigh the costs of acting responsible.

Nevertheless obvious shortcomings in BESTSELLER’s social responsibility reporting hinder the efficient usage of reputation effects as a safeguard. The lack of transparency in the corporate social reporting can diminish a company’s reputation (Hess, 2008). An unfavourable reputation of the CSR-Initiating company itself does not help to integrate sound CSR-Strategies throughout the supply chain. This problem is also going to be addressed in the next chapter.
7.6. Transparency

According to Koch (1995) and Pedersen and Andersen (2006) the paper explained the theoretical value of reputation effects, trust, goal congruence, third party interventions and direct sanctions and use this to analyze how BESTSELLER is making use of them. In the following paragraph it will be shown how these safeguard mechanisms can be amplified by introducing another safeguard mechanism, transparency.

As described above, informational asymmetries between the principal and the agent after the contract is signed leads to the risk of moral hazard and opportunistic behaviour. A high degree of transparency, first in the relationship between principal/buyer and agent/supplier and second in the relationship between buyer and its stakeholders, can essentially help to safeguard the COC by lowering informational asymmetries between the parties. Transparency in the buyer-supplier relationship requires that the supplier's discloses all its production facilities, production processes and allows audits at any given time. If suppliers have to meet high transparency standards in order to be accepted as a supplier, buyers can lower their audit efforts and benefit from considerable cost-savings. Increased transparency in this regard can lead to a higher level of trust in the relationship and thus amplifies the functionality of this safeguard mechanism.

On the other hand, a transparent buyer-supplier relationship requires that the buyer discloses and communicates the results of conducted audits to its suppliers, this leads to an intensified dialog between the two parties. Long-term relationships and the fostering of intensive dialog is essential to relay on goal coherence and trust as efficient safeguard mechanisms.

The additional introduction of industry wide supplier portals, where suppliers have to reveal their social and environmental production practices is conceivable (Pedersen and Andersen, 2006). A consequent usage of such a portal could encourage competition among the suppliers. An outstanding performance regarding CSR-Measures would be

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46 Chapter 7.6 was developed together with Johannes Bachmann and therefore cannot be assigned to only one person. Both persons are equally responsible for the content of the chapter.
rewarded by an increased amount of orders and could lead to a competitive advantage of well performing suppliers. Suppliers would be in a position where they can signal COC compliance to the whole industry network. Thus, reputation effects as an important safeguard mechanism will gain increased importance if higher levels of transparency are introduced industry-wide.

Transparency in the relationship between a company and its stakeholders is morally important because it enhances an attitude for honesty, openness, and commitment to truth. It can be argued that transparency enhances the accountability and responsibility of a firm (Dubbink et al., 2008, p. 393). Transparency makes it easier to for stakeholders to confront a company with its actions. Therefore, transparency enables effective third party monitoring – the public can act as a monitoring party. Audit activities, previously undertaken by the company can partly be shifted to different stakeholders outside the firm. In this regard, transparency works as additional safeguard mechanism and helps to get suppliers in line with the companies COC.

Nevertheless, full transparency can also be harmful for a company. Disclosing information may lead to a strategic disadvantage of the company. For achieving transparency in the relationship between a company and its stakeholders Hess (2008) defines certain pillars, central for a sound corporate social reporting strategy.47 Hess's discloser pillar requires that corporations provide their stakeholders with all relevant and material information relevant to the corporation's social and environmental policies (Hess, 2008). This includes information about all active suppliers, including their production facilities, production processes as well as the results of audits undertaken. The question remains if firms rather try to activate potential benefits or if the focus on the possible addition costs of engaging in transparent relationships.

BESTSELLER is making use of transparency as an effective safeguard only partially. The company puts a strong emphasis on transparency in the relationship with its suppliers but

47 According to Hess (2008) corporate social reporting should consist of three pillars: discloser, dialog, and development.
shows substantial shortcomings on corporate social reporting and the relationship with its external stakeholders can be characterized as non-transparent.

The company requires that all suppliers’ production sites entered into the audit program prior to the integration in the supplier portal and the placement of orders. Suppliers should ensure that factories are open and honest during audits and that the auditor is allowed full access to the site and the true records. BESTSELLER uses its supplier rating system in order to track if suppliers are in compliance with the companies COC and communicate these results through its supplier IT-Portal. Furthermore, the companies engagement in long term relationships and strong dialog facilitate the emerge of a transparent supplier-buyer relationship.

However, BESTSELLER shows substantial shortcomings when it comes to transparency in the relationship with other external stakeholders. The corporate social reporting is inadequately. It is important to notice that from the website communication, it is impossible to know if the majority of BESTSELLER’s suppliers are at the top of the BESTSELLER rating scales or at the bottom. Hence, the rating scales would be much more relevant for external stakeholders if BESTSELLER also communicated their results and not only the fact that it exists. Also, BESTSELLER is unwilling to publish the names of their suppliers for competitive reason (Interview – BESTSELLER)48. The lack of transparency makes it impossible for stakeholders to critically assess the companies CSR-Measures and undermines the company’s credibility. Thus, BESTSELLER neglects possible benefits of involving the public and other stakeholders in audit process and resigns to use transparency as an efficient and cost-effective safeguard mechanism.

48 Further shortcommings are to be mentioned, but lay beyond the scope of this paper
8. Conclusion

Since the definition of codes of conduct are written in a blurry and indefinite way, safeguarding mechanism and monitoring are essential to assure compliant behaviour of suppliers and sub-contractors. We used the principal agent model to analyze the conflict of interests between different actors in a global supply chain and assigned BESTSELLER the role of the initiator (principle) and the suppliers the role of the agents. Under this framework we analysed how BESTSELLER is making use of safeguard mechanisms in order to circumvent problems occurring in a principal-agent relationship. We illustrated the classical safeguard mechanisms based on Koch (1995) and Andersen and Pedersen (2006) using the case of BESTSELLER and underlined the importance of transparency as an additional safeguard mechanism.

We found that BESTSELLER focuses on safeguards like goal coherence and trust while neglecting other safeguard mechanism like transparency or reputation effects. The company engages in long-term relationships and in a strong dialog with its suppliers, which facilitates the development of trust and goal coherence. To a limited extend BESTSELLER makes use of direct sanctions as an effective safeguard. The engagement in long-term relationships makes this instrument less attractive. Currently, third Party interventions are an additional tool in BESTSELLERS safeguarding strategy.

While understanding the necessity to give suppliers appropriate incentives, BESTSELLER neglects the use of specific important safeguarding mechanisms. Since there is no disclosure of BESTSELLERS suppliers and sub-suppliers, reputation effects help only to a limited extent to safeguard the companies COC. Transparency, first in the relationship between the principal and the agent and second in the relationship between buyer and its stakeholders, is missing. Shortcomings in this regard limit the efficiency of existing safeguard mechanisms. Suppliers cannot gain competitive advantage by acting responsibly if their actions are not visible to the market. At the same time the public cant help to safeguard the supply chain if proper reporting for customers is not available.

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49 Chapter 8 was written together with Johannes Bachmann and therefore cannot be assigned to only one person.
Assuming BESTSELLER is willing and able to address these shortcomings the question remains, do suppliers have the resources to fulfil Code of Conduct requirements? Considerable initial investments on behalf of the initiating company might be necessary. Further research has to be conducted to analyse if this strategies is in line with the initiating company’s interests. Higher switching costs and increased sunk costs of mutual investments might weaken the bargaining position of the initiating company compared to its suppliers.

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**10.5. Interview with Anja Bremholm**

_S: How do you define your companies CSR-strategy?_

**Anja Bremholm:** Our general CSR-strategy is to integrate sustainability into our whole organization, including own as well as suppliers’ operations. In regards to our supply chain our overall aim is to increase transparency and enable our suppliers to take full ownership for social responsibility within their production chains.

_S: What is one of BESTSELLER biggest successes in CSR?_

**Anja Bremholm:** It is difficult to point out one thing. We wrote down our first Code of Conduct (COC) in 2002, and since then we have come far with our work. But in order to keep making progress we must also look at our internal practices. This year we have started up a training program for our designers and buyers that aim to teach them how their everyday decisions may have an influence on our suppliers’ ability to follow our Code of Conduct. It is our belief that this knowledge will help them better make the right decisions.

_S: Does BESTSELLER have a specific application process for the suppliers your company considers to work with? Is there an effort to engage with your suppliers in long-term relationships?_

**Anja Bremholm:** Once a BESTSELLER buyer has found a new supplier that s/he wants to do business with, s/he contacts the Corporate Sustainability department for an approval of the supplier. If the supplier is new (not used by any BESTSELLER brand), we will make an initial audit to check if the factory conditions are in compliance with our COC. One supplier may very well own several factories, and all factories that are used for making BESTSELLER products must be approved before taken into production. If the conditions are in full compliance with our COC or the supplier is willing to work on improving the issue(s) that may have come up during the audit, the factory will be approved for production, and our auditors will pay them a visit later to follow up on the issue(s) that needed to be solved. Issues of a certain character will need to be solved before we can approve the factory for production. We have worked with many of our biggest suppliers for a very long time, and it is our belief that close long-term relationships are preferable in order to ensure the best COC results. Mutual trust and understanding are the main pillars of a good relationship, and that is not established overnight. It is our impression that the
longer we have worked with a supplier, the better he understands the motives behind our COC.

S: Why is BESTSELLER not disclosing their suppliers?

Anja Bremholm: That is a decision we have made seen from a competitive perspective.

S: Does your company have implemented a certain system (e.g. traffic light system) for the performance measurement of your suppliers?

Anja Bremholm: Yes, we have implemented a rating system that indicates how far our suppliers have come with their work in meeting our requirements. We do not expect that the supplier is rated green right from the beginning, but he must show the will to improve and work towards the goal of becoming green. If he doesn’t show this will, we will terminate our cooperation with him.

S: Is BESTSELLER performing internal or external auditing? What are the specific auditing mechanisms of your company?

Anja Bremholm: In BESTSELLER, auditing is not just a matter of control, but also a way of getting closer to our suppliers. It is our belief that we will get the best results if we work closely together. Instead of only imposing restrictions on our suppliers, we also engage in dialogue with them in order to gain a common understanding. However, to save our internal auditors’ time we have decided to outsource the initial audits to external auditing companies. This way our internal auditors will have more time to work with the core issue, namely to help our suppliers improve the conditions.

S: What kind of problems does BESTSELLER face concerning its suppliers? What happens if one of the suppliers is not in line with BESTSELLERs code of conduct? How to you deal with sub-suppliers in means of the company’s code of conduct?

Anja Bremholm: Two of the biggest problems are long working hours and incorrect salaries. Besides that, different management issues can cause problems. If the supplier is not willing to work on improving the problems, we will terminate our cooperation with him. We demand that our suppliers pass down our Code of Conduct to sub-suppliers and expect these to follow it just like our main suppliers. However, as our supply chain is very long and complex, it can be very difficult to map all sub-suppliers and ensure that they follow our COC.
**S:** Is your company trying to support the suppliers in order to meet the requirements of BESTSELLERs code of conduct?

Anja Bremholm: Yes, we offer our suppliers training in how to meet our requirements, and our local auditors assist them as much as they need during the whole process.

**S:** How does BESTSELLER engage in stakeholder dialogue?

Anja Bremholm: Our main platform of communication is The Danish Ethical Trading Initiative (http://dieh.dk/in_english/who_we_are/) which we started up together with other companies, NGO’s and trade unions in 2008. In this forum we engage in dialogue with other stakeholders over various issues. For instance we just had a meeting with the NGO Clean Clothes Campaign last week where we discussed “living wages”. We listen to them and try to come up with solutions to the things they have on their agenda.

It is important to us to have an open dialogue with all stakeholders, and we always take the time to answer questions from customers, students, NGO’s etc. Besides that we communicate with our stakeholders through our corporate website, and in the nearest future also through printed material for customers and other people who may have an interest in our work.
Einverständniserklärung zur Verwendung der Seminararbeit:

„How BESTSELLER safeguards its global supply chain - an evaluation of BESTSELLER's way of dealing with CSR in their supply chain“

Mit diesem Schreiben erkläre ich... Johannes Bachmann... mich einverstanden, dass Frau Sarah Ivansits die oben genannte Arbeit im Rahmen Ihrer Masterarbeit verwertet.

Frau Sarah Ivansits hat mir ihre Masterarbeit zur Ansicht übermittelt und ich bin mit ihren Änderungen einverstanden.

Weiters wird es ihr auch erlaubt, die Originalarbeit der Masterarbeit im Anhang anzufügen.

Ort, Datum... Varel... 07.03.2011... Unterschrift... J. Bach...
Ausbildung

01/2010 – ?
Universität Wien, Betriebswirtschaftliches Zentrum, Österreich
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Diplomarbeit: „Corporate Social Responsibility in Global Supply Chains with respect to the principal agent theory“
- Ausgewählte Kurse: Industrial Organization, Industrial Management (Prof. Wirl), Strategisches Management
- Diplomprüfung: 23.September 2010

01/2011 – 07/2011
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Praktische Erfahrung

05/2013 - ?
Welldone Werbung und PR GmbH
- Executive Consultant Assistant
- Projektmanagement

02/2013– 04/2013
Projektarbeit, Mahlzeit Karte GmbH, Wien, Österreich
- Kundenstammsaufbau
- Kalt - / Warmakquise

02/2012 – 03/2013
Peek & Cloppenburg, Wien, Österreich
- Fashion Management Trainee
- Abteilungsleitung: Boutique, Herren - Exquisite

07/2011 – 01/2012
Bestseller, Only, Wien, Österreich
- Sales Assistant
- Inventarmanagement

10/2009 – 01/2011
Bundesministerium für Arbeit, Soziales und Konsumentenschutz, Wien, Österreich, Controlling, Vollzeit
- Erstellung von Kennzahlen für die interne Kostenrechnung & Quartalsberichten
- Grundsatzfragen und Analyse der Pensionsversicherung
- Entwicklung relevanter Kennzahlen
- Berichtswesen und Öffentlichkeitsarbeit der Sektion

07/2009
Bundesministerium für Arbeit, Soziales und Konsumentenschutz, Wien, Österreich, Controlling, Internship