

FAILURE OF THE CORPORATE RESPONSIBILITY SYSTEM IN A LARGE MULTINATIONAL CORPORATION CASE STUDY “DIESELGATE”

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Abstract: *Corporate Social Responsibility (CSR) is an important factor of the positive image of corporations and their competitiveness. However, in some cases, serious misconduct occurs in this area. The article summarizes the results of qualitative research into the failure of the Volkswagen Group’s corporate social responsibility system. The purpose of this research, conducted in the form of a case study, was to elucidate the causes and consequences of fraudulent behavior of falsifying the results of exhaust emission tests for diesel-powered cars. It was found that the main cause was the Group’s organizational culture characterized by very strong elements of competition where the strategic goal had to be met at any cost. If necessary, it would include ways that are contrary to the ethical code. The whole sophisticated CSR system of the Volkswagen Group fatally failed in this case. The consequences became evident mainly in a significant reduction in the market value of the Group and a decrease in investors’ confidence. It is clear that the experience of this case goes significantly beyond the limits of the Volkswagen Group. It can be assumed that it will significantly affect the behavior of companies not only in the automotive industry, but also in other sectors. Further to this case, the critique of the current CSR concept is also becoming more intense and the first impulses to redesign this concept have started to occur.*

Keywords: *Corporate Social Responsibility, Case study, Sustainability Report, Code of Conduct, Volkswagen Group, Dieselgate.*

JEL Classification: *L62, M14*

Introduction

In September 2015, the United States Environmental Protection Agency (US EPA) announced that diesel-powered Volkswagen vehicles included software that enabled to significantly reduce the production of emissions during emission control. In response to these findings, the Volkswagen Group admitted after some delay that the fraudulent software was installed in a total of about 11 million vehicles. After the broad media coverage of this case, which came to the attention of the wider public as the Dieselgate case, the Group’s CEO Martin Winterkorn resigned and an extensive investigation was launched (Slovák, 2016).

1 Problem formulation

Can this case of corporate social responsibility failure be considered unique? Of course not. There are a number of cases of unethical behavior of such entities, and some of them even have a more significant impact than this case in terms of the seriousness of the consequences.

From the most famous ones, we can recall two major disasters, whose demonstrable cause was the fatal neglect of occupational safety at factories located in poor countries. In 1984, there was a leak of toxic gas from the factory of Union Carbide, an American corporation, in the Indian city of Bhopal. About 20,000 people died of the consequences. In 2013, the Rana Plaza textile factory building collapsed on the outskirts of the Bangladeshi capital of Dhaka. There were more than 800 dead in the ruins and about 2,500 people were injured (Blažek, Šafrová, 2013).

Financial scandals represent a peculiar group. Although they did not result in drastic losses of human lives, their consequences involved large property losses. Klusoň (2010) analyzes the cases of Enron, Artur Andersen, Ahold, Parmalat and many other corporations that became victims of fraudulent behavior of their top management at the beginning of the twenty-first century. The value of their shares fell and their shareholders' ownership rights were damaged significantly. Coffee (2005) shows that the common cause was the dispersed ownership of these corporations that made it impossible for the owners to supervise top management sufficiently.

The Dieselgate case does not belong to any of the above groups, however. Neither employees nor customers were directly injured. The fraudulent behavior that covertly allowed exceeding the emission limits in the normal use of cars damaged to an unprecedented extent the public interest in environmental protection.

Serious failure of the Volkswagen Group in the field of corporate social responsibility raises questions that ask about both the causes and consequences of this scandal. Searching for answers has become the objective of this qualitative research conducted in the form of a case study. The results are presented in the following parts of this paper.

However, firstly we present a brief overview of the theoretical definition of the corporate social responsibility concept and the methodological aspect of using the case study for the implementation of the qualitative research.

2 Theoretical and methodical basis

2.1 Corporate Social Responsibility (CSR)

Corporate Social Responsibility is a major competitiveness factor in today's globalized markets. However, the theoretical basis of this phenomenon began to appear about a hundred years ago. In his article from the year 1916, Clark criticizes capitalism and promotes a new model of business ethics. He states that "if men are responsible for the known results of their actions, business responsibilities must include the known results of business dealings, whether these have been recognized by law or not." (Clark, 1916, p. 223). According to McGuire, "the idea of social responsibilities supposes that the corporation has not only economic and legal obligations but also certain responsibilities to society which extend beyond these obligations." (McGuire, 1963, p. 144).

In the second half of the twentieth century, Carrol (1999) brings an analysis of the development of the CSR concept. Although the concept of this phenomenon has been under discussion for many decades, its generally valid and world-recognized definition does not yet exist. Kašparová and Kunz claim that CSR is based on volunteering and it

does not have clearly set boundaries, which provides space for a very broad and varied understanding of this concept (Kašparová, Kunz, 2013). However, analyses of CSR definitions show that there are five basic dimensions that occur most frequently. It is the stakeholder dimension, the social dimension, the economic dimension, the dimension of volunteering, and the environmental dimension (Dahlsrud, 2008, p. 5).

The tool which companies can use to inform their stakeholders and the wider community about their CSR activities is CSR reporting. In its processing, corporations can use one of the many standards that the CSR reporting field offers. These include, for example, the OECD Guidelines for Multinational Corporations, ISO 14000 and ISO 26000, standards Global Reporting Initiative and Global Sullivan Principles, and others.

The tools of Corporate Social Responsibility system implementation also include ethical audit and ethical code.

Claiming social responsibility is a voluntary commitment of a corporation, which thus declares its awareness of the social overlap of its business. Corporations assume part of the responsibility for the development of the society and its direction, beyond what is required by law. Although this commitment is voluntary, assuming CSR is nowadays becoming a standard, especially for large multinationals. The concept of social responsibility emphasizes behavior in accordance with ethical principles and requirements of sustainable development.

2.2 Research method

As mentioned above, the analysis of the Dieselgate case was conducted using the case study method.

Case study is one of the basic methods used in social sciences for qualitative research. While a relatively small amount of data from a large number of subjects (cases) is collected and evaluated in a statistical survey, which is typical of quantitative research, a case study involves the collection and evaluation of a large amount of data about one or a few cases, respectively. A case study is about capturing the complexity of the case, describing the relationships in their entirety (Hendl, 2005).

A case study always involves a combination of different techniques for collecting information. The most commonly used information sources are: “documentation, archival records, interviews, direct observations, participant-observation, and physical artifacts.” (Yin, 2014, p. 101).

The purpose of case study application is to understand the context of the whole case. “It is assumed that by thorough examination of one case we will understand other similar cases. At the end of the study, the case under consideration is interpreted in a broader context.” (Hendl, 2005, p. 104).

Yin defines the case study as “a strategy for examining a predetermined phenomenon ... within its real context, especially when the boundaries between the phenomenon and the context are not entirely clear” (Yin, 2014, p. 16). Case study is “a suitable research method if we need to answer how and why questions, with a focus on current events” (Yin, 2014, p. 9).

In relation to the topic of our research, we have formulated two research questions:

- What were the causes of this failure?
- What were the consequences of this failure?

Finding answers to both of these questions has led to meeting the goal of the research, which is the analysis of the case with the possibility of generalizing the conclusions made.

While respecting the above principles of application of the case study method, we first dealt with the characteristics of the object, i.e. the Volkswagen Group, and the characteristics of its external environment, i.e. the car market. Then, we focused on the analysis of the causes and consequences of the Group's corporate social responsibility failure. The discussion of the results focused mainly on understanding the context of the whole case, searching for the possibility to generalize the acquired knowledge, and predicting the development in the given field.

We used publicly available sources for the research. We used mainly articles published in specialized journals as well as daily newspapers, the Volkswagen Group's corporate resources, various sources of statistical information, press releases of rating companies, and a number of other publicly available resources. The information obtained was analyzed and compared so as to ensure their credibility and objectivity.

There is no doubt that information from the ongoing investigation would be very beneficial; but of course, it was not available to us.

3 Problem analysis

3.1 The Group's characteristics

The Volkswagen Group (henceforth also the VW Group) is one of the largest corporations in the world. The parent company of the Group is Volkswagen Aktiengesellschaft (Volkswagen AG), which holds controlling shareholdings in seven other joint-stock companies. They produce a total of twelve makes of passenger cars, trucks and motorcycles. Specifically, the makes of passenger cars are Volkswagen, Škoda, Seat, Audi, Bentley, Bugatti, Lamborghini, or Porsche, the makes of trucks are Volkswagen, Scania, or MAN, and Ducatti motorcycles.

Porsche Automobil Holding SE (30.8% share), Qatar Holding LLC (14.6%) and the Federal State of Lower Saxony (11.8%) are the three largest shareholders in the Group. However, as Slovák explains in detail, the voting rights are quite different from ownership interests. The Federal State of Lower Saxony holds a privileged ownership position as it can veto the decisions taken at the shareholders' meetings despite its capital position (Slovák, 2016, p. 30). The VW Group can be classified as a so-called semi-state company. A number of distinctive figures of the German political life were members of the Group's board of directors in the past. The state's ingerence towards this subject has always been and still is extremely important. This stems from its extraordinary importance to the German economy. The Group employs more than 280,000 workers in the Federal Republic of Germany and indirectly generates hundreds of thousands of jobs (Barthel, K., Böhler Baedeker, S., Bormann, R. et al., 2015). The automotive industry is the largest industrial sector in the German economy. In 2016, its turnover accounted

for €404 billion (Automotive Industry 2017). In 2015, the company's spending on research and development was more than 7% of total R&D investment in Germany. Cars and automotive components make up 18% of the volume of German exports.

The Volkswagen Group also holds a significant position on the global scale. In 2015, before the Dieselgate case, it was ranked 49th in the ranking of the world's largest multinational corporations, measured by their market value. Within the automotive sector, it was second. It employed approximately 600,000 employees (Global 500, 2015). In that year, it produced about 10 million cars, accounting for about 12% of the world's passenger car market.

3.2 Basic tools of the Group's corporate social responsibility system

In connection with the case, it is important to mention the way of implementing the corporate social responsibility system in the Volkswagen Group. The basic tools are the Code of Conduct and CSR reporting.

The Code of Conduct is the basic document that formulates the ethical maxima of the Volkswagen Group and all the controlled companies (Volkswagen AG 2015).

From a research point of view, it is essential that the Code puts great emphasis on the ecology and responsibility of each employee. The company also devotes relatively large space to management responsibility. All managers are responsible for compliance with rules within their field of responsibility.

Both the VW Group and its controlled companies publish regular CSR assessments in the form of a report called the Sustainability Report. It is compiled in accordance with the G4 Sustainability Reporting Guidelines of the Global Reporting Initiative program and is reviewed by the renowned PricewaterhouseCoopers auditing company (Volkswagen AG, 2014).

The document is written in a very high-style language and is infused with the ethos of responsibility, sustainability and ecology. In the section on business values, the report states: "We know that growth can only take place hand in hand with responsibility and environmental protection." (Volkswagen AG, 2014, p. 14). In a total of 156 pages, the term "environment" is used 335 times!

In September 2015, the Volkswagen Group even ranked first in the prestigious CSR ranking of the Dow Jones Sustainability Index. According to the comment on the evaluation, "sustainability is the very basis of the Group's policy."

Note: A few days after the scandal broke out, the VW Group was completely removed from the ranking with reference to the proven manipulation of emission tests (Volkswagen AG to be removed from the Dow Jones Sustainability Indices, 2015).

3.3 Specific features of the external environment of the automotive industry

The external environment of the automotive industry is characterized by three specific features.

The first specific feature is the high competition on the world passenger car market. This creates strong pressure to lower prices. According to a study by the Automotive Research Center of the university in Duisburg-Essen, which is based on data for the first

half of 2016, the profit margins of the largest car manufacturers range from 4 to 8%. The VW Group's profit margin was 4.5% (Ulrich, 2016). However, it is not only about the pressure on the purchase price of cars, but also about the pressure to reduce operating costs, i.e. the reduction of fuel consumption. This leads to increasingly more challenging technical and economic measures that car manufacturers must implement because of their competitiveness.

Another important feature is represented by the ever-increasing tightening of governments' demands to reduce emissions of harmful substances. The technical solutions that make it possible to meet these standards are very costly. As the former CEO of the VW Group, Martin Winterkorn, said: "The reduction in CO₂ emissions of one gram costs us in our fleet average a hundred million euros for development ... It's a hundred million euros that we have to pay in advance without knowing if this investment will return." (Dvořák, 2014).

The third specific feature is represented by the fact that the world's leading carmakers are both economically and socially important subjects, and therefore they may experience the "too big to fall" syndrome; in other words, it is the assumption that in case of bankruptcy they can anticipate the help of the state. This leads to moral hazard. It can be said that this fact can be very significant in the case of the VW Group. As mentioned above, the Group is an extremely important entity with a significant influence on the German economy. The Federal State of Lower Saxony is the Group's significant shareholder with a privileged co-ownership position.

3.4 The Group's expansion strategy

In 2007 the Volkswagen Group wrote up the "Strategy 2018" document where it formulated its goal to become the global leader in the passenger car market. An important factor for this strategy should have been the expansion of diesel-powered cars in the US market. However, this market is characterized by a number of specifics, as commented by Slovák in detail (Slovák, 2016, p. 32).

In 2008, the Group launched the "Clean Diesel" project, based on the concept of "Powertrain and fuel strategy". It involved the development of diesel engines that would be economical and at the same time they would meet very strict emission limits. An engine marked as BlueTDI was developed to meet even the strictest emission standard in the United States, i.e. California's "Tier2 Bin5" standard. The implementation of the project had a positive response and the annual sales of VW cars on the US market increased almost 1.7 times between 2010 and 2015.

However, in 2013, first suspicions regarding compliance with emission standards occurred. It was the findings of the California Air Resources Board (CARB), in whose laboratories the tests were conducted and which contacted the carmaker asking for an explanation. The Volkswagen Group responded relatively quickly. It recalled over 400,000 cars for calibration and informed CARB about the remedy. However, repeated tests showed that the correction was ineffective.

Another measurement of the Group's car emissions was conducted in May 2014 by West Virginia University. These measurements confirmed that real-time emissions are many times higher than those measured in the test mode.

Testing organizations reported their findings to the Federal Environmental Protection Agency of the United States (EPA). On that basis, EPA officially launched an investigation into violations of environmental laws on 18 September 2015. The Group was charged with equipping some types of diesel engines with a program that allowed falsification of the emission test results. EPA assumes that the Group's actions were deliberate in order to violate US environmental laws (EPA, 2015).

As we mentioned at the beginning of this paper, CEO Martin Winterkorn admitted on 22 September 2015 that the Group had committed what it was charged with. He announced opening the case investigation by an external agency (Rushe, 2015). He subsequently resigned, but denied any fault of his own; after that Matthias Müller took his place.

Martin Winterkorn's admission gave rise to an extensive response across the globe and triggered the launch of investigations in many countries. Shortly, on 24 September 2015, the British Ministry of Transport launched its own investigation (Wearden, 2015). Two days later, it banned the sale of most of the diesel cars branded as Volkswagen Switzerland (Ruddick, 2015a). Investigations were also launched in Italy, Spain, France, South Korea, and China. The European Investment Bank also launched its investigation on suspicion that the Volkswagen Group had used EU public funds in the form of loans and grant funds in connection with the case.

4 Research results and their discussion

The results of the qualitative research conducted by the case study method result in answers to the two research questions that relate to the causes and consequences of corporate responsibility failure of the Volkswagen Group.

4.1 The causes of the Group's corporate social responsibility failure

An analysis of available information suggests that the primary cause was the strategic goal of becoming the world's largest carmaker by 2018. This goal was set out in 2007 in the above-mentioned "Strategy 2018" document. This goal was followed by another one to significantly expand the VW Group's presence in the North American diesel-powered car market.

Strenuous efforts to meet these extremely ambitious strategic goals, regardless of the strong competition prevailing in the global car market, and in particular of the ever-tightening emission standards, led to evolutionary changes in the Group's corporate culture that proved to be negative in the context of the case. Demanding goals had to be fulfilled unconditionally, any questioning of their feasibility was perceived as a manifestation of incompetence or disloyalty.

An environment of extreme competition where weakness is not forgiven and where there is no "I cannot" was established. Renowned German automotive journalist Christiaan Hetzner writes about a dominant atmosphere of fear and blind obedience (Hetzner, 2015). Hans Dieter Pötsch, Chairman of the Group's Board of Directors, said in December 2015 that the failure was caused by a chain of causes, including tolerance for breach of rules (Ruddick, 2015b). Symptoms of this unfortunate development could be traced back in a number of other sources (Slovák, 2017).

The key issue was the expansion in the North American market. A dilemma occurred there: either try to comply with stringent emission standards through a very costly technical solution, or circumvent emission testing by installing fraudulent software.

Solving the dilemma through fraudulent behavior could have several reasons. Experience showed that if similar cases (although smaller) occurred in the past, car manufacturers were usually able to trivialize them, or identify them as a technical error or measurement inaccuracy. A significant role may also have played the feeling of reduced responsibility associated with the sense that the VW Group was protected by the state. The decision to install fraudulent software represented a pragmatic way out of a crisis situation, but the revealing risk and its consequences were underestimated.

Of course, our research did not seek to find the specific culprits. These can be proven only by means of a police investigation. However, the conducted analyses provide a more or less unambiguous conclusion that it was not a separate action of a few engineers. It can be reasonably assumed that the people who decided on the solution, implemented it, or at least knew about it, or could know about it, included a number of managers in relatively high positions of the Group's hierarchy.

It should also be pointed out that the formally highly rated system of corporate social responsibility of the Group, based on the Volkswagen Code of Conduct and Sustainability Report, as mentioned above, was unable to prevent the unethical conduct.

4.2 Consequences of the Group's corporate social responsibility failure

The consequences of the fraudulent behavior were analyzed for volumes of car sales of the VW Group, its share value, and its rating.

It is evident from the VW Group's car sales figures and their comparison with competing manufacturers that the situation analyzed did not have any demonstrable negative consequences on the total sales volume (Schmitt, 2016). Hence, it can be concluded that customers do not perceive the Group's fraudulent behavior as a significant problem because it does not represent a "defect" that would affect the performance of a car, its operating costs, reliability or safety.

On the other hand, the negative impact of the analyzed case on the stock market is quite clear. In 2015, the Group's shares reached the peak of €230 per share in April. Then a gradual decline associated with the first signs of the fraudulent behavior followed. On 18 September 2017, when EPA officially charged VW with falsifying tests, the stock price was just €160. After that a steep fall followed. The lowest share price was recorded on 5 October, amounting to €102, which was a drop to only 42% of the highest value in that year. In the following months, the share price slightly increased. At the beginning of 2017, it started to reach the level of €150, but it did not exceed it in the next period.

The case was clearly reflected in the Group's rating. Moody's rating agency responded immediately as it reduced its rating from grade A2 with a positive outlook to grade A3 with a negative outlook on 24 September 2015 (Moody's, 2015). Both grades are in the upper-middle rating range, but the negative outlook implies further reduction of the rating.

Standard & Poor's rating agency assessed the VW Group at the end of 2015 with grade BBB+ with a negative outlook (lower-middle quality of the rating range) whereas before the emission affair broke out, the corporation was rated with grade A (S&P, 2015). According to S&P, the reputation and perception of the VW brand deteriorated, which would negatively affect the Group's market position. In addition to lower earnings and cash flow due to lower sales and prices, the expected fines and litigation costs would also have a negative impact.

Similarly, Fitch Ratings agency also reduced its rating. According to the agency, the worse rating reflects problems in the Group's administration and management and its internal control. Inability to reveal such fraud is a serious mistake of the Group's top management (Fitch Ratings, 2015).

What wider implications of the case can be expected and what generalizations can be made?

There is no doubt that the consequences of a severe breach of corporate social responsibility are a great warning not only for the VW Group itself, but also for other companies operating in the automotive industry and other sectors. Volkswagen paid a high price for the scandal through a significant reduction in its market capitalization, a fall in investors' confidence, substantial fines and compensation, and a number of lawsuits that can take many years (Slovák, 2016, p. 54). It can therefore be expected that this experience will generally contribute to strengthening the belief that fraudulent behavior is subject to a high risk in the environment of fierce competition and strong state supervision, and hence does not pay.

The VW Group's unethical behavior also provoked an intense discussion about the current concept of CSR and the way it is evaluated. According to many authors, the emission scandal seriously disrupted this concept and caused serious damage to the social responsibility movement (Greer, 2016). There were also voices calling for a fundamental redefinition of the CSR concept (Rhodes, 2015). Leon Kaye notes that a situation such as this could be expected. The CSR evaluation was long focused on the formulation of appealing goals and aspirations instead of concrete and tangible results (Kaye, 2015). However, despite this, it cannot be expected that this case will lead to the abandonment of this concept as its real alternative does not exist; rather, it will be improved.

Conclusion

It is clear that the corporate social responsibility system is not self-sustaining and its implementation is not in itself a guarantee that a company will always act ethically. This is evidenced by the above-mentioned "Dieselgate" scandal. An analysis of this case shows that in the environment of fierce competition prevailing in global markets unethical behavior carries a high risk with the threat of great losses. It can be assumed that corporations will ensure in their own interest that the CSR system is not only a PR tool, as is often the case, but an effective means of promoting and controlling their ethical behavior.

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