
UNIT 3 CORPORATE GOVERNANCE AND BUSINESS ETHICS

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3.1 INTRODUCTION

As the Indian economy becomes more industrialized and the corporate sector continues to acquire an increasingly important profile, a number of issues continue to spring into prominence. While ensuring growth is important, ensuring that it takes place in an ethical, just and inclusive manner is even more important. Corporate governance lies at the heart of the way businesses are run. Often defined as the ‘way businesses are directed and controlled’, it concerns the work of the board as the body which bears ultimate responsibility for the business.

The Oxford Dictionary defines ethics as “moral principles that govern a person’s behaviour or the conducting of an activity”. When we add the word ‘corporate’ before ethics, we obviously are trying to ensure that the day-to-day conduct of business concerns confirms to the existing norms of accepted behaviour. By definition, ethics go beyond the rules of conduct laid down by laws etc. The Unit focuses on various dimensions of the concerns that relate to corporate governance and business ethics.

After studying this unit, you should be able to:

- Explain the significance of corporate governance and ethics in business
- Differentiate between ethics and law
- List the essentials of good corporate governance
- Discuss the approaches to ethical decision making
- Explain the meaning and importance of corporate ethics

3.2 CORPORATE GOVERNANCE

Governance relates to how the board is constituted and how it performs its role. It encompasses issues of Board composition and structure, the Board’s remit and how it carried out different functions and the framework of the Board’s

accountability to its stakeholders. It is also concerned with how the Board delegates authority to manage the business throughout the organization. The words 'Corporate Governance' (CG) are buzzwords these days due to various corporate failures the world over in the recent past. Corporate governance represents the value framework, the ethical framework and the moral framework under which business decisions are taken. In other words, when investment takes place across national borders, the investors want to be sure that not only is their capital handled effectively and adds to the creation of wealth, but that the business decisions are also taken in a manner which is not illegal, or do not involve moral hazards (Verma & Gupta, 2004). Corporate governance basically denotes adherence to rule of law.

3.2.1 Elements of Good Corporate Governance

Good corporate governance is a formal system of accountability and control of ethical and socially responsible decisions and the use of available resources. To be effective, a company's leaders must take responsibility for their decisions and the performance of the organization as a whole. For example, the leaders of a company should design and adhere to a code of ethics that helps management promote each of the important characteristics of good corporate governance. Corporate governance requires companies to develop and closely monitor comprehensive and robust programmes and mitigate any number of possible risk factors. Each company must eventually tackle corporate governance, and unfortunately, there is no easy way to go about this. Corporate governance is a complex and tiresome subject.

Corporate governance can overwhelm growing companies that are just beginning to realize the importance of tackling this issue, which in the end becomes a full-time job. The UK Corporate Governance Code, which guides many businesses, states that the corporate board sets the values of the company, and this is very different from running the business day-to-day.

Below are eight elements of good corporate governance:

1) Direction

Providing overall direction for the business, its leaders and employees is a major part of corporate governance. Making strategic decisions and discussing current and future concerns of the company are tactics of this element. Company mission and vision statements stem from the governance role of business. These statements provide a sense of purpose and illustrate primary motives for the company's business activities.

2) Independence of Directors

If the directors of a company are also the owners and/or their family members, entrepreneurs appointed by friends, or individuals who are involved in the daily management of the company, then the board is unlikely to be impartial. Having a majority of non-executive independent directors would help avoid prejudice and conflicts of interest between the board and the management. Independent judgment is almost always in the best interest of the company.

3) Effective Risk Management

Even if a company implements smart policies, competitors might steal its customers, unexpected disasters might cripple operations and economic

fluctuations might erode the buying capabilities of the target market. One can't avoid risk, so it's vital to implement effective strategic risk management. For example, a company's management might decide to diversify operations so the business can count on revenue from several different markets, rather than depend on just one.

4) Organization

A solid structure and organization within the company is essential towards fluidly implementing and dispersing corporate governance objectives. Companies will need to be able to monitor all of their dealings, interactions, and transactions effectively. One of the fundamental objectives of corporate governance is for companies to develop more transparent business practices, meaning a rigidly structured framework through which it is possible to trace all such activities efficiently.

5) Stakeholder Relations

Corporate governance encompasses a business's accountability to each of its stakeholder groups. Traditionally, this role has largely centered around investor relations and communication of company decisions. Investors can often find contact information of board members on company websites. In the early 21st century, there is more emphasis on balancing investor interests with concerns of other stakeholders, such as customers, employees and business partners.

6) Transparency

Managers sometimes keep their own counsel, limiting the information that filters down to employees. But corporate transparency helps unify an organization. When employees understand management's strategies and are allowed to monitor the company's financial performance, they understand their roles within the company. Transparency is also important to the public, who tend not to trust secretive corporations.

7) Corporate Citizenship

Another major evolution in the early 21st century is increased focus on corporate citizenship. Companies commonly include a corporate citizenship statement on corporate governance or investor relationships web pages. Such statements communicate the business's intent to act with social and environmental responsibility. Philanthropy and other charitable contributions are among common things noted within corporate citizenship statements. In general, governance includes awareness that companies should balance profit-generating activities with responsible policies and practices.

8) Self-Evaluation

Mistakes will be made, no matter how well a company is managed. The key is to perform regular self-evaluations to identify and mitigate brewing problems. Employee and customer surveys, for example, can supply vital feedback about the effectiveness of the company's current policies. Hiring outside consultants to analyze operations can also help identify ways to improve the company's efficiency and performance.

3.3 BUSINESS ETHICS

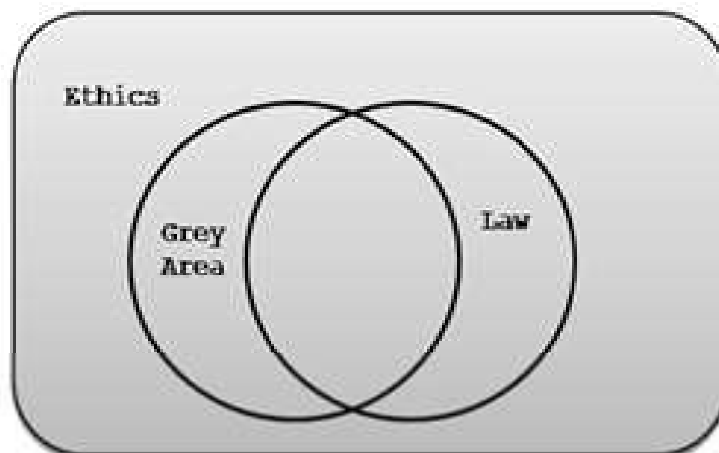
Business ethics are a kind of applied ethics. It is the application of moral or ethical norms to business. The term ethics has its origin from the Greek word 'ethos', which means character or custom- the distinguishing character, sentiment, moral nature, or guiding beliefs of a person, group, or institution. Ethics area set of principles or standards of human conduct that govern the behaviour of individuals or organizations.

Ethics can be defined as the discipline dealing with moral duties and obligations, and explanation regarding what is good or not good for others and for us. Ethics is the study of moral decisions that are made by us in the course of performance of our duties. Ethics is the study of characteristics of morals and it also deals with moral choices that are made in relationship with others. Business ethics comprises the principles and standards that guide behaviour in the conduct of business. Businesses must balance their desire to maximize profits against needs of its stakeholders. Maintaining this balance often requires trade-offs. To address these unique aspects of businesses, rules, articulated and implicit, are developed to guide the businesses to earn profits without harming individuals or society as a whole.

3.3.1 Difference between Ethics and Law

While law is obligatory and violation of law attracts penalties from the justice system, ethics are more voluntary in nature. However, not acting ethically might lead to violation of laws, as most laws are in one way or the other a codification of ethics.

Business ethics can be said to begin where the law ends. Business ethics is primarily concerned with those issues not covered by the law, or where there is no definite consensus on whether something is right or wrong. Business ethics is about the grey areas of business, where values are in conflict. In such scenarios, there might not be a definitive 'right answer'.



3.4 APPROACHES TO ETHICAL DECISION MAKING

There are several approaches to ethical decision making. They are discussed in brief in this section.

3.4.1 Teleology

Teleology is the belief that certain phenomena are best explained in terms of purpose rather than cause. Teleological theories of ethics focus on the consequences arising out of actions. There are two major classes of teleological theories - egoism and utilitarianism.

i) Egoism

Egoism is the view that morality ultimately rests on self-interest. It defines right and wrong in terms of the consequences to oneself. An egoist chooses a course of action out of several available choices on the basis of what effects the chosen action would have on his well-being. When faced with a business decision, such a person would thus choose the course of action that he or she believes would best serve his/her self-interest.

ii) Utilitarianism

Utilitarianism is the system of ethics according to which the correctness or incorrectness of an action should be judged by its consequences. The goal of utilitarian ethics is to promote the greatest happiness for the greatest number. Jeremy Bentham, an English philosopher, was the founder of utilitarianism; John Stuart Mill was its best-known defender.

The utilitarian approach can also be understood as a cost-benefit analysis. The costs and benefits of a decision, a policy, or an action are compared. The costs and benefits can be measured on any criteria such as economic, social, human, or even emotional. When all the costs are added and compared with the results, if the benefits outweigh the costs, then the action may be considered ethical.

Utilitarianism and egoism are similar in that both advocate judging actions by their consequences. However, unlike egoism, utilitarianism is concerned with ensuring the greatest good for the greatest number of people.

3.4.2 Deontology

The word deontology originates from the Greek words for duty (deon) and study (logos). As opposed to the teleological theories, deontological theories focus on the morality of the means and not on the ends.

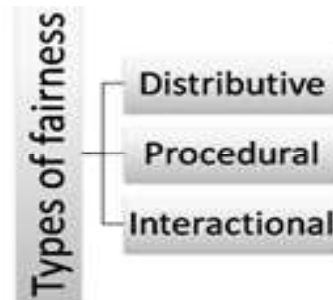
A deontological approach to decision making would, thus, not allow harming some individuals in order to help a larger number. To the deontologist, each person must be treated with the same level of respect and no one should be treated as a means to an end.

3.4.3 Justice

Justice implies fairness. Justice-based theories of ethics are concerned with determining the fairness of actions. Under this approach, any action that is fair to

all affected parties and is in consonance with existing ethical or legal standards, is a just action.

Fairness of an action is often judged on three grounds—distributive, procedural and interactional. Each of these is briefly described below.



1) Distributive Fairness

Distributive fairness judges the outcomes of actions and perceptions of these outcomes that the parties affected by these have of them.

2) Procedural Fairness

Procedural fairness deals with the processes (for example: policies, procedures, rules, etc.) that are employed to reach decisions. Under this approach, the fairness of processes as well as outcomes of these processes is determined.

3) Interactional Fairness

This dimension of fairness is concerned with the treatment one receives in the administration of a decision making process. Basically, this deals with the respect and consideration shown towards the affected parties while taking decisions. It also deals with the explanations and justifications provided for the decisions.

3.4.4 Relativism

As opposed to the approaches discussed so far, all of which are based on the premise that principles of morality that are permanent and universal in nature, relativism states that there are no universal principles of ethics and that right and wrong must be determined by each individual or group. It thus takes into consideration differences in morality across time and cultures.

Activity 1

If a manufacturer chooses to produce its products in countries that have non-existent labour laws, will its action be considered ethical? Why?

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Check Your Progress - 1

Notes: a) Write your answers in about 50 words.

b) Check your answer with possible answers given at the end of the unit.

1) Define corporate ethics.

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2) Differentiate between ethics and law.

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3.5 INDIVIDUAL ETHICAL DECISION MAKING

The most popular model of ethical decision making was developed by James Rest (Rest, 1984) and is called the four-step or four-stage model of individual ethical decision making.



The four stages of decision making, as proposed by the model are:

i) Ethical Issue Recognition

This is the first stage in the ethical decision-making process. In this stage, an individual identifies a situation and the ethical issues involved therein.

ii) Ethical Judgment

In the second stage of the process, after having identified the ethical issues involved, an individual would form a normative opinion about the rightness or wrongness of the issue.

iii) Ethical Intent

In the third stage, having identified the ethically correct courses of actions open to him/her, the individual decides what he or she will do (or not do) in regard to the perceived ethical dilemma. Research indicates that individuals do not always form intentions in accordance with their judgments, as various situational factors may act to influence the individual otherwise.

iv) Ethical Behaviour

This is the final stage of the decision-making process. Having identified the ethical issues involved, the ethically acceptable choices open and having formed an intent to behave in a particular way in the earlier three stages, the individual finally carries out his/her intent and acts in a particular manner.

3.5.1 Difficulties in Identifying the Scope of Ethics in Business

Businesses have to align their values and mechanisms to standards acceptable to not only their shareholders, but also to their customers, business partners, regulators, government and the community at large. Thus, the narrow theoretical view that seeks to limit all business activity to maximizing shareholder wealth is impracticable at best.

Similarly, the broader view that seeks to judge all business activity through an ambiguously defined test of morality is also defective as morals by definition are subjective and also dynamic. When the values of consumers and employees change and when a shared consensual culture is replaced by a more heterogeneous one, it is no longer possible to rely on implicit understandings.

Given the difficulties involved in identifying the scope of ethics in business, it is better to establish a written code of conduct that governs business practices in different scenarios. Unless business ethics are aligned to broader perceptions of ethical conduct, problems are bound to arise. Additionally, in a culturally fluid environment, a formal code of ethics is as essential as codes governing decision making in other dimensions such as financial transactions. However, at the same time, such a code of ethics needs to be both sophisticated and flexible, in order to be effective in handling different ethical dilemmas a business is likely to face across time, cultures and geographies.

Table 1.1 summarizes important ethical issues confronted by businesses from the 1960s onwards (adapted from Ferrell *et al* 2006)

Table 1.1: Important Ethical Issues Confronted by Businesses

1960s	1970s	1980s	1990s	2000s
Environmental issues	Employee militancy	Bribes and illegal contracting practices	Sweatshops and unsafe working conditions in Third World countries	Cyber crime
Civil rights issues	Human rights issues	Influence peddling	Rising corporate liability for personal damages	Financial management
Increased employee-employer tensions	Covering up of ethically questionable actions	Misleading advertising	Financial mismanagement, fraud	International corruption

Honesty	-	Financial fraud	-	Loss of employee privacy
Changing work ethics	-	Transparency issues	-	Intellectual property theft
Rising drug use	-	-	-	-

Although Table 1.1 lays out the issues from the perspective of American business history, many of the concerns highlighted above hold true for the Indian business environment as well. Questions such as privacy at the workplace, intellectual property theft, corruption and financial mismanagement are equally important in India as in rest of the world.

3.6 IMPORTANCE OF CORPORATE ETHICS

3.6.1 Why Corporate Ethics Matter?

Ethics matter because ethical conduct is the right conduct. However, in the absence of a time- culture, and context-neutral definition of ‘right’, it is very difficult to develop a code of conduct on this basis alone. It basically says that businesses avoid many risks and gain reputation by acting in an ethical manner.

A good ethics process, operationalized in such a way that all decision making procedures and structures support it on a day-to-day basis, will give an organization the best chance possible for finding out about potential problems early so that they can be dealt with before they become a disaster. There are also market advantages to be gained from an ethical reputation.

3.6.2 Ways in which Ethics are Important

Major scandals such as WorldCom, Enron, Lehman Brothers etc., in the US and Satyam in India tell us why ethical business practices are becoming increasingly important. There are several reasons why ethics are important to business:

- 1) To understand reasons behind increasing influence of corporates in society.
- 2) To ensure that no harm is done to society.
- 3) To meet ethical expectations more effectively.
- 4) To enable companies to identify employee and customer concerns at an early stage.
- 5) To improve the quality of a firm’s relationships with its key stakeholders.
- 6) The government is interested in ensuring ethical business practices to ensure a basic level of integrity in the marketplace. This promotes international competitiveness of the economy and improves a country’s image concerning ease of doing business.
- 7) Even domestically, predictable levels of ethical behaviour ensures that costs of business such as transaction costs, hedging and insurance etc., are kept to a minimum.
- 8) Unethical behaviour imposes costs on the government and taxpayers. Bad behaviour by a few impacts on all businesses and might also have an adverse impact on the country’s international competitiveness.

- 9) Ethics can help improve decision making by providing managers with the appropriate knowledge and tools that allow them to correctly identify, diagnose, analyse, and provide solutions to the ethical problems and dilemmas they are confronted with.
- 10) Ethics help in analysing the reasons behind this, and the ways in which such problems might be dealt with by managers, and regulators in improving business ethics.
- 11) Business ethics can provide us with the ability to assess the benefits and problems associated with different ways of managing ethics in organizations.
- 12) Business ethics also equips us with knowledge that goes beyond the traditional boundaries of business studies.

Activity 2

Illustrate a business case in which ethical practices have created a strong public image for the corporate.

3.7 GOVERNANCE: CASE STUDIES

Understanding ethical behavior in the context of corporate governance requires two levels of analysis: the internal concerns of corporate agency and the emergent effects on social welfare.

Corporate agency is based on the premise that employees, managers, and directors (i.e., agents) should behave in the best interests of owners or shareholders (i.e., principals). Two things get in the way of that ideal:

- First, managers’ interests, while overlapping with those of shareholders, are distinct. Sometimes agents can help themselves in ways that hurt the firm and its shareholders. Examples include shirking, waste, and in extreme cases, fraud or other self-serving actions that can bring down the company, as have happened in numerous business scandals.
- Second, shareholders have neither the specific knowledge nor skills possessed by management. This can create dynamics where even well-intentioned managers may feel compelled to ‘short-termism’, i.e., acting in ways that look good to shareholders now, but actually undermine value creation over time. Various oversight, transparency, and incentive mechanisms have evolved, and continue to develop, to contain agency costs.

Social welfare is based on the premise that companies should engage in fair dealing with all of their stakeholders—including customers, employees, suppliers and communities, as well as shareholders—in accordance with the expectations of the larger society in which they operate. The debate about what is ‘fair dealing’ reflects the larger, ongoing debate about the purpose of corporations in society, but even a shareholder-centric model recognizes that companies benefit from at least nurturing their reputations among all stakeholders, and that minimizing their negative externalities (pollution, plant closures, etc.), preserves the freedom of companies to operate with otherwise minimal external constraints.

While traditional corporations are expected to prioritize shareholder interests above those of other stakeholders and, to a considerable extent, attempt to maximize shareholder value within their legal constraints, other corporate forms permit a more balanced approach between shareholders and vendors (cooperatives) or between shareholders and specified other constituencies (B-corporations).

*Certified B Corporations are businesses that meet the highest standards of verified social and environmental performance, public transparency, and legal accountability to balance profit and purpose.

CASE STUDIES

FAILURES

The Enron Scandal (Hodak, 2007): How a combination of perverse incentives and lack of transparency killed a highflying company?

Enron’s collapse is generally viewed as a morality tale - the natural result of managerial greed, a clueless board, and feckless gatekeepers. It is a tale of how bad bets that resulted in good outcomes came to be viewed by top management and the board as bets kept repeating on an ever-larger scale. Early success in highly risky ventures were ramped up and duplicated, under perverse incentives, into a financial disaster. The firm then doubled down on that disaster with non-economic hedges developed by the finance group. The CFO (Chief Financial Officer), in a wholesale breach of his fiduciary responsibilities, including corruption of various gatekeepers, managed to cloak the poor quality of his hedges and his motivation in creating them. This duplicity prevented top management or the board from fully recognizing or acting upon the danger that those hedges posed to Enron’s survival, until it was too late. The political and economic reactions to Enron are usefully viewed in terms of these distinguishing elements of its failure.

SUCCESSSES

Progressive Insurance: Disclosure Strategy (Hutton Weber, 2001): How they won by not playing “the earnings game.” An excellent example of voluntary disclosure yielding a competitive advantage.

Progressive Insurance had refused to play Wall Street’s earning game. Progressive didn’t manage reported earnings nor did management give guidance to analysts. Management then considered taking their unique disclosure strategy one step further to become the first to move to monthly reporting of operating results. Significant benefits had accrued from Progressive’s refusal to play the earnings game. Management’s time wasn’t wasted manipulating reported results or talking

to analysts and reported numbers didn't mislead internal or external decision making. However, there were significant costs, as well. Unguided analysts' forecasts were often well off the mark, causing Progressive's stock price to fluctuate widely around quarterly earnings announcements. Analysts' forecasting abilities seemed to be getting worse - during four consecutive quarters in 1999-2000, management felt compelled to give mid-quarter warnings that earnings would fall significantly below the First Call's consensus estimate. To eliminate the need for such mid-quarter warnings, management considered moving to monthly reporting of operating results. With this data, analysts presumably would be able to update their forecasts. Management must decide if the release of monthly results would give competitors information to use against Progressive, and if the release of monthly results would increase or decrease Progressive's stock price volatility.

Check Your Progress - 2

Notes: a) Write your answers in about 50 words.

b) Check your answer with possible answers given at the end of the unit.

1) What are the four stages of decision making?

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2) Define corporate ethics. Why do ethics matter?

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3.8 LET US SUM UP

Questions of ethics, or the right way to run a business, are inherent in all aspects of corporate governance and in every Board decision and action. Ethical choices are relevant within the core business strategies that Boards pursue and the way that direct the business as a whole to achieve them. Ethics is the first line of defense against corruption while law enforcement is remedial and reactive. Good corporate governance goes beyond rules and regulations that the government can put in place. It is also about ethics and the values which drive companies in the conduct of their business. It is therefore all about the trust that is established over time between companies and their different stakeholders. Good corporate governance practice cannot guarantee no corporate failures. But the absence of such governance standards will definitely lead to questionable practices and

corporate failures which surface suddenly and massively. In making ethics work in an organization it is important that there is synergy between vision statements, mission statements, core values, general business principles and code of conduct confers a variety of benefits. An effective ethics programme requires continual reinforcement of strong values. Organizations are challenged with how to make its employees live and imbibe the organization's codes and values. To ensure the right ethical climate, a right combination of spirit and structure is required.

3.9 KEYWORDS

Corporate Governance : Corporate governance represents the value framework, the ethical framework and the moral framework under which business decisions are taken.

Code of Ethics : A code of ethics document may outline the mission and values of the business or organization, how professionals are supposed to approach problems, the ethical principles based on the organization's core values and the standards to which the professional is held

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3.11 CHECK YOUR PROGRESS- POSSIBLE ANSWERS

Check Your Progress - 1

- 1) Ethics is "Moral principles that govern a person's behavior or the conducting of an activity". When we add the word 'corporate' before ethics, we obviously are trying to ensure that the day-to-day conduct of business concerns confirms to the existing norms of accepted behavior. By definition, ethics go beyond the rules of conduct laid down by laws.
- 2) While law is obligatory and violation of the law attracts penalties from the legal justice system, Ethics are more voluntary in nature. However, not acting ethically might lead to violation of laws, as most laws are in one way or another a codification of ethics.

Check Your Progress - 2

- 1) The four stages of decision making, as proposed by the model are: Ethical Issue Recognition, Ethical Judgment, Ethical Intent, and Ethical Behaviour
- 2) Corporate Ethics or Business Ethics has been defined as The study of business situations, activities and decisions where issues of right and wrong are addressed. (Crane and Matten: 2010). According to another definition "Business Ethics comprises the principles and standards that guide behaviour in the world of business" (Ferrell et al 2006).

Ethics matter because ethical conduct is the right conduct. However, in the absence of a time, culture, and context-neutral definition of 'right', it is very difficult to develop a Code of Conduct on this basis alone. It basically says that businesses avoid many risks and gain reputation by acting in an ethical manner.