ABSTRACT

Effective Corporate Governance (CG) – Ethical Perspectives

Apprehension about Corporate Governance has increased in response to major crises of confidence, trust, fraud, market failure, and the change in our opinion about the role that corporations play in the economy and society. This paper attempts to answer some basic questions, the pertinent among them are; what is Ethical Corporate Governance? Why has Ethical Corporate Governance come to the forefront in today's times? Does it make business sense to invest in an Ethical Corporate Governance structure? Does an ethical and effective Corporate Governance aid Sustainability? The paper highlights some best practices in Corporate Governance. The paper concludes by reiterating the fact that, Ethics is truly an essential ingredient for better business achievement and it will continue to serve as the blueprint for success in the 21st century. Ethical Corporate Governance practices inspire in companies the necessary vision, processes, and structures to make decisions that guarantee longer-term sustainability

Key Words: Ethical Corporate Governance

Effective Corporate Governance (CG) – Ethical Perspectives

"Good corporate governance is about 'intellectual honesty' and not just sticking to rules and regulations. Capital flowed towards companies that practiced this type of good governance." - Mervyn King (Chairman: King Report)

Apprehension about Corporate Governance has increased in response to major crises of confidence, trust, fraud, market failure, and the change in our opinion about the role that corporations play in the economy and society. One look around the Board of Enron Corporation, the American energy company based in Houston - Texas in 2000 would instill confidence in any investor who could be assured that the company was in the hands of legal, ethical, political, and economic leaders. Surely they would be sufficient gatekeepers. In addition to Kenneth Lay and Jeffrey Skilling, there were 15 external directors whose resumes were impeccable. Ironically the Enron scandal in October 2001, eventually led to the bankruptcy of the Enron Corporation, and the dissolution of Arthur Andersen, which was one of the five largest audit and accountancy partnerships in the world.

Large and trusted companies from Parmalat in Italy, to the multinational newspaper group Hollinger Inc., and WorldCom the telecom giant, revealed significant and deep-rooted problems in their Corporate Governance. Even the prestigious New York Stock Exchange had to remove its Director, Dick Grasso, amidst public outcry over excessive compensation. Closer to home, as quoted in Live mint .com dated 7th Jan 2009, 'Nasscom expressed shock at the accounting fraud disclosure made by Satyam's Chairman Ramalinga Raju, terming the incident as a failure of Corporate Governance'. It is obvious that something is amiss in the area of Corporate Governance all over the world.

The mantra followed by the corporate management in the past was maximizing `shareholder value' which is a measure of the financial rewards delivered to shareholders through the combination of cash (dividends and share buy-backs) and the capital gains achieved on public or private equity markets. The rise of shareholder and consumer activism, the broadening of its investor base, the partnership between the private and public sectors, the retraction of statutory regulation and the democratization of the workplace have all influenced the shape of business and the redefinition of organizations as social organisms. It is in this context that an increasing focus on Business Ethics and Corporate Governance has emerged and will continue to accelerate, as host societies demand greater transparency from business and more jealously guard their right to confer or withdraw its ‘social license to operate’.

This paper attempts to answer some basic questions from a basic perspective, the pertinent among them are; what is Ethical Corporate Governance? Why has Ethical Corporate Governance come to the forefront in today’s times? Does it make business sense to invest in an ethical, Corporate Governance structure? Does ethical and effective Corporate Governance aid Sustainability? Comprehend some best practices in Corporate Governance?

Ethical Corporate Governance

Definitions of Corporate Governance vary widely. They tend to fall into two categories. The first set of definitions concerns itself with a set of behavioral patterns: that is, the actual behavior of corporations, in terms of such measures as performance, efficiency, growth, financial structure, and treatment of shareholders and other stakeholders. The second set concerns itself with the normative framework: that is, the rules under which firms are operating—with the rules from sources such as the legal system, the judicial system, financial markets, and factor (labor) markets. Sir Adrian Cadbury author of "The Financial Aspects of Corporate Governance", London Stock Exchange: London, December 1992, defined CG; "Corporate governance is.... holding the balance between economic and social goals and between individual and communal goals. The governance framework encourages the efficient use of resources equally to be accountable for the stewardship of these resources. The aim is to align as nearly as possible the interests of individuals, corporations, and society."

Kidder (1995) defines ethics as “*obedience to the unenforceable*”. Legal compliance mechanisms tend to promote a *rule-based or the stick approach* which corresponds to the *letter of the law* which may not necessarily inspire or instill excellence, whereas, ethical compliance mechanisms promote a *principle-based or the carrot approach* which corresponds to the *spirit of the law*. Table – 1, high lights the major differences in Legal and Ethical compliance approaches.

Table 1. Differences in Legal and Ethical Compliance approaches

Factors	Legal	Ethical
Ethos	Regards ethics as a set of limits and something that has to be done	Defines ethics as a set of principles to guide choices
Objectives	Geared towards preventing unlawful conduct	Geared towards achieving responsible conduct
Method	Emphasizes rules and uses increased monitoring and penalties to enforce these rules	Treats ethics as infused in business practice (leadership, core systems , decision making processes etc)
Behavioral Assumptions	Rooted in deterrence theory (how to prevent people from doing bad things by manipulating the costs of misconduct)	Rooted in individual and communal values (both material and spiritual)

Adapted from Paine (1996)

Arthur Levitt, former chairman of the US Securities & Exchange Commission stated, "If a country does not have a reputation for strong and ethical corporate governance practices, capital will flow elsewhere. If investors are not confident with the level of disclosure, capital will flow elsewhere. If a country opts for lax accounting and reporting standards, capital will flow elsewhere. All enterprises in that country suffer the consequences."

Forms of Corporate Governance are shaped nationally by their economic, political and legal backgrounds, by their sources of finance, and by the history and culture of the countries concerned. Scholarly debates on Corporate Governance have turned on the advocacy of different approaches and theories. But perception is in the eye of the beholder, while Corporate Governance, is a technical term for accountants and lawyers, for a lay person or readers of a popular newspaper or an ordinary citizen who is about to invest his life's saving in a company , it would mean terms such as honesty, decency, fairness and return on his investments. The central issue today is not whether most listed companies act in accordance with the various compliances and provisions of the Sarbanes-Oxley, King, SEBI etc. More importantly, it is whether the Board of Directors and the Top Management of large organizations and that of business in general, is honest, and fair in the eyes of the general public and all its stakeholders.

Significance of Ethical Corporate Governance

One reason, mentioned earlier, is the explosion of scandals and crises. But these are just symptoms of a number of structural reasons why Corporate Governance has become more vital for economic development and a more significant policy issue in many countries especially in these uncertain times. Some important reasons are;

- First, privatization has raised corporate governance issues in sectors that were previously in the hands of the state. Firms have gone to public markets to seek capital, and mutual societies and partnerships have converted themselves into listed corporations.
- Second, programs of deregulation and restructuring have reshaped the local and global financial scene. Long-standing institutional corporate governance agreements are being replaced with new institutional arrangements, but in the meantime, inconsistencies and gaps have emerged.
- Third, the mobilization of capital is increasingly one step removed from the principal-owner, given the increasing size of firms and the growing role of financial intermediaries. The role of institutional investors is growing in many countries, as many economies are moving away from "pay as you go" retirement systems. This increased delegation of investment has raised the need for good corporate governance arrangements.
- Fourth, due to technological progress, liberalization and opening up of financial markets, trade liberalization, and other structural reforms, price deregulation and the removal of restrictions on products and ownership—the allocation within and across countries of capital, become more complex, as has monitoring of the use of capital. This makes good governance more important, but also more complicated.
- Fifth, international financial integration has increased, and trade and investment flows are increasing. This has led to many cross-border issues in corporate governance. Cross-border investment results in meetings of corporate governance cultures that are at times uneasy.

Hence, it is evident that more now than ever before, Ethical Corporate Governance is essential for a corporate aspiring to be a responsible business. It is increasingly recognized that this includes an affirmation of the company's commitment to corporate responsibility and sustainability.

Ethical Corporate Governance and its Effects on Development and Sustainability

The research literature has identified several channels through which Corporate Governance affects growth and development. These are;

- The first is the increased access to external financing by firms. This in turn can lead to larger investment, higher growth, and greater employment creation. Financial and capital markets are better developed in countries with strong protection of property rights, as demonstrated by the law and finance literature. In particular, better creditor rights and shareholder rights have been shown to be associated with deeper and more developed banking and capital markets.
- The second channel is a lowering of the cost of capital and associated higher firm valuation. This makes more investments attractive to investors, also leading to growth and more employment. The quality of the corporate governance framework affects not only the access to and amount of external financing, but also the cost of capital and firm valuation. Outsiders are less willing to provide financing and are more likely to charge higher rates if they are less assured that they will get an adequate rate of return.
- The third channel is better operational performance through better allocation of resources and better management. This creates more wealth generally. Better corporate governance can add value by improving the performance of firms, whether through more efficient management, better asset allocation, better labor policies, and similar efficiency improvements. Evidence for the United States (Gompers, Ishii, and Metrick 2003), Korea (Joh 2003), and elsewhere strongly suggests that at the firm level, better corporate governance leads not only to improved rates of return on equity and higher valuation, but also to higher profits and sales growth.
- Fourth, good corporate governance can be associated with a reduced risk of financial crises. This is particularly important, as financial crises can have large economic and social costs. In countries with weaker investor protection, net capital inflows were more

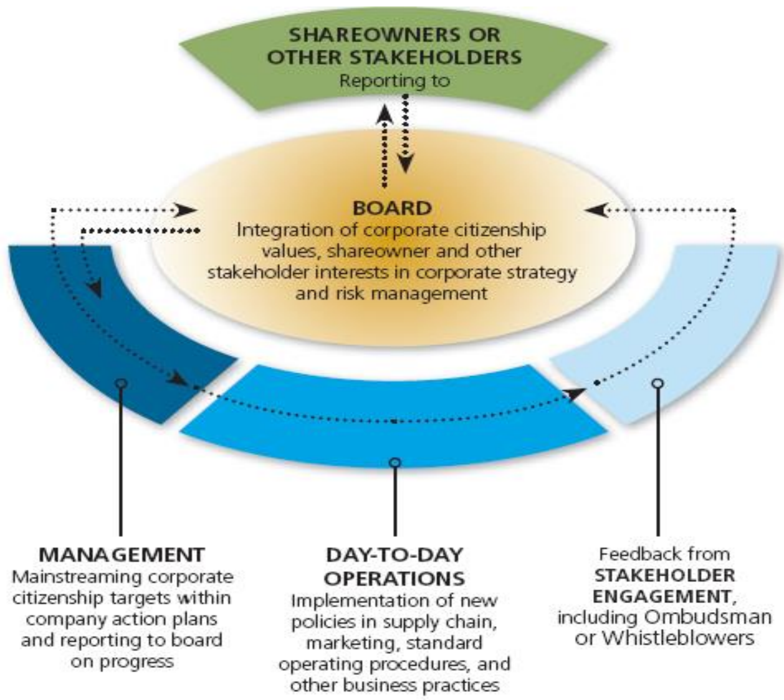
sensitive to negative events that adversely affect investors' confidence. In such countries, the risk of expropriation increases during bad times, as the expected return of investment is lower, and the country is therefore more likely to witness collapses in currency and stock prices.

- Fifth, ethical corporate governance can mean generally better relationships with all stakeholders. Besides the principal owner and management, public and private corporations must deal with many other stakeholders, including banks, bondholders, labor, and local and national governments. Each of these monitor, discipline, motivate, and affect the management and the firm in various ways.

Sustainability is a broad and evolving construct that defies a universally agreed definition. Most definitions of *sustainability* draw on the principles of the Brundtland Commission: "Meeting the needs of the present without compromising the ability of future generations to meet their own needs" (WCED, 1987: 8). An emerging consensus is that there are three pillars of sustainability; namely, economic, social, and environmental (Elkington, 1998; Schmidheiny, 1992; Rondinelli & Berry, 2000; Bansal, 2005). *Economic sustainability* is fundamental to corporate financial success—in the long run the corporation simply cannot survive if expenditure exceeds income. *Social sustainability* embodies the humanitarian context of business and relates to issues of poverty and income inequality; disease, especially HIV/AIDS; access to health care, clean water, and sanitation; education, especially for females; and broader problems associated with the impact of globalization on economic development. Third, *environmental sustainability* considers the impact of business on the quality and quantity of natural resources, the environment, global warming, ecological concerns, waste management, reductions in energy and resource use, alternative energy production, and improved pollution and emissions management (Townsend, 2008). The three pillars of sustainability are closely related, and their impacts deeply interconnected (Stern, Young, & Druckman, 1992; Gladwin, Krause, & Kenelly, 1995; Scaltegger & Synnestvedt, 2002; Townsend, 2008).

Ethical Corporate Governance practices instill in companies the essential corporate citizenship, vision, processes, and structures to make decisions that ensure longer-term sustainability in terms of profits as well as achieving environmental, social, and economic value for society. The figure below shows how responsible business and sustainable profits are embedded into the function of the board.

Fig 1. Corporate Governance and Sustainability



Katherine Ankele, Head of Corporate Research for the Institute for Ecological Economy Research, Berlin, propagates the agenda for “Sustainable Corporate Governance.” According to Mrs. Ankele, ,"The scope of an enlargement of corporate governance towards ‘Sustainable Corporate Governance’ depends…on the ability of corporations to reflexive self-regulation, [where]… sustainability must be integrated into core strategies and decisions of corporations in order to persist even in times of decreasing public interest and retreat of policy to selective issues."

The above discussion supports the evidence that, ethical Corporate Governance has an impact on the sustainability of the organization as well as on the growth and development of the economy.

Corporate Governance - An Indian Perspective

In the Indian perspective it would be worth a mention that, as in any other country, the legal system plays a crucial role in creating an effective Corporate Governance mechanism and protecting the rights of investors and creditors. This system encompasses two important aspects – the protection offered in the laws (*de jure protection*) and to what extent the laws are enforced in real life (*de facto protection*). In India, enforcement of corporate laws remains the yielding underbelly of the legal and corporate governance system. From the many examples of corporate failures and scandals it is evident that, the Board of Directors has been largely ineffective in monitoring the actions of management. Often the company Boards are packed with friends and allies of the promoters and managers, in brazen violation of the spirit of corporate law. The Board of Directors has often functioned as rubber stamps of the management.

It is imperative the Indian companies realize, Ethical Corporate Governance is characterized by a firm commitment and adoption of ethical practices by an organization across its entire value chain and in all of its dealings with a wide group of stakeholders encompassing employees, customers, vendors, regulators and shareholders (including the minority shareholders), in both good and bad times. In other words they have an effective system of Corporate Governance. Corporate Governance of India has undergone a paradigm shift. Some of the milestones are stated below;

- In 1996, Confederation of Indian Industry (CII) took a special initiative on Corporate Governance. The objective was to develop and promote a code for Corporate Governance to be adopted and followed by Indian companies, in the Private Sector, the Public Sector, Banks or Financial Institutions. This initiative by CII flowed from public concerns regarding the protection of investor interest, especially the small investor, the promotion of transparency within business and industry. A National Task Force was set up. The Task Force presented the draft guidelines and the code of Corporate Governance (Desirable Corporate Governance Code) in April 1997(at the National Conference and Annual Sessions of CII)
- SEBI established in 1988. The Government of India's securities watchdog, the Securities Board of India, announced strict Corporate Governance norms for publicly listed companies in India. Clause 49 was revised by the SEBI, to enhance the Corporate Governance (CG) requirements,

primarily through increasing the responsibilities of the Board, consolidating the role of the Audit Committee and making management more accountable. Some of the concerns addressed were; whistle blower policy, disclosures, audit committees, code of conduct for board of directors etc.

- Narayana Murthy Committee recommendations include role of Audit Committee, related party transactions, Risk management, compensation to Non- Executive Directors, Whistle Blower Policy, Affairs of Subsidiary Companies, Analyst Reports and other non-mandatory recommendations.
- Ministry of Corporate Affairs – Government of India released "Corporate Governance Voluntary Guidelines, 2009" during India Corporate Week during December, 14-21, 2009 expecting India Inc. to adhere to such guidelines ethically to achieve highest standard of corporate governance.
- Cl.49 of the listing agreement has been amended six times since its inception, viz., 9th March 2000, 12th September 2000, 22nd January, 2001, 16th March 2001, 31st December 2001 and 29th October, 2004.

Sadly, in our country even though the government and the other regulatory agencies try to tighten the leash on companies in terms of accountability, transparency and mandatory disclosures and though there is a lot of talk about Corporate Governance, nothing much happens in reality due to the mindsets of people who govern and manage the organizations. It is a world where the end and not the means are important. Decisions leading to business ethics boiling down to a personal and not an organizational call are taken every day to succeed and more importantly survive. Indian companies need to be more proactive in creating an ethical culture and climate, and Corporate Governance structures rather than be reactive and operate in a purely compliance mode. Therefore our need of the hour is strong Ethical Corporate Governance and an enabling corporate culture and climate.

Ethical Corporate Governance – Best Practices

International best practice recommendations for effective Corporate Governance can be broadly classified into three areas: 1) the independence of the Board, 2) the responsibilities of institutional investors or shareholders, and 3) the transparency of business structure and operation. It would be imperative to discuss each practice briefly and its implications from the ethical perspectives on the Corporate Governance of organizations.

Board Independence

Independence, objectivity and an irreproachable business reputation are the distinguishing characteristics of an Independent Director**.** In view of Agency theory, the presence of non-executive directors in the board of the firms and their supervisory performance as independent individuals, remarkably contributes the declined conflicts of interests existing between shareholders and directors of the firm. Non-executive directors can be regarded as "professional referees whose task is to stimulate and oversee the competition among the firm's top management" (Fama, 1980, p. 294).

Independent Directors are expected to act honestly and in good faith in the best interests of the company. This means that if there is conflict between the interests of the company and the people they represent as nominees, they are required by law to think of the best interests of the company and not of the people who nominated them. Ethical behavior does not just require Directors to behave ethically personally; it also requires them to see to it that the company conducts its business in accordance with the law and with a high standard of commercial morality. It is also important to remember that Directors' fiduciary duty means that they must comply with the spirit of the law and not just the letter of the law. Fiduciary duty of Directors is not just to shareholders, but also to customers and clients as well; all the more so, if what is being offered is highly technical, complex and opaque with the potential to lose clients their money. Directors must devote enough time to remain familiar with the changing nature of the company's business and environment, including mastering the impact on the business and its risk profile of the evolving political, legal, social and competitive context in which the company operates. They must understand the organizational and reporting structures with sufficient knowledge of the top and the second line of managers, to contribute towards succession planning strategies. Directors cannot abuse their access to confidential information and use such information for "insider trading" nor can they divulge any confidential information without the proper approval of the Board.

Responsibilities of Institutional Investors or Shareholders

Years ago, investors were typically individuals or families, irrespective of whether or not they acted through a controlled entity. Over time, markets have become largely *institutionalized*: investors are largely institutions that invest the pooled funds of their intended beneficiaries. These institutional investors include pension funds (also known as superannuation funds), mutual funds, hedge funds, exchange-traded funds, and financial institutions such as insurance companies and banks. In this way, the majority of investment now is described as "institutional investment" even though the vast majority of the funds are for the benefit of individual investors.

Ethical Corporate Governance mechanisms and controls are designed to reduce the inefficiencies that arise from moral hazard and adverse selection. For example, to monitor managers' behavior, an independent third party (the external auditor) attests the accuracy of information provided by management to investors. Internal corporate governance controls may include mechanisms like monitoring by the board of directors, internal audits and control procedures, and balance of power.

Transparency of Business Structure and Operation

Investors steer clear of companies that lack transparency in their business operations, financial statements or strategies. Companies with inscrutable financials and complex business structures are riskier and less valuable investments. Mounting evidence suggests that the market gives a higher value to firms that are upfront with investors and analysts. Transparency pays, according to Robert Eccles, author of "Building Public Trust – The Value Reporting Revolution". Eccles shows that companies with fuller disclosure win more trust from investors. Relevant and reliable information means less risk to investors and thus a lower cost of capital, which naturally translates into higher valuations. The key finding is that companies that share the key metrics and performance indicators that investors consider important are more valuable than those companies that keep information to themselves.

Financial reporting fraud, including non-disclosure and deliberate falsification of values also contributes to users' information risk. To reduce these risks and to enhance the perceived integrity of financial reports, corporation financial reports must be audited by an independent external auditor who issues a report that accompanies the financial statements. The Board must insist there is no conflict of interest, which places the integrity of financial reports in doubt due to client pressure to appease management.

Conclusions

Ethics is truly an essential ingredient for business success and it will continue to serve as the blueprint for success in the 21st century. Corporate Governance is constantly changing and evolving and these changes are driven by both internal and external environmental dynamics. There is a growing realization that Ethical Corporate Governance is a must not only to gain credibility and trust but also as a part of strategic management for survival, consolidation and growth and sustainability.

Another important aspect is to realize that ultimately the spirit of Corporate Governance is more important than the form. Substance is more important than style. Values are the essence of Corporate Governance and these will have to be clearly articulated and systems and procedures devised, so that these values are practiced. The government or the regulatory agencies at best can provide certain environment, which will be favorable for such an attitude, but the primary responsibility, is of the people especially the members of the Board of Directors and the Top Management. Successful Corporate Governance underscores the importance of adopting systems that ensure adherence to ethical business practices, spotting deviations and curbing them since unethical practices reduce productivity, drain resources, and cause significant behavioral issues.

Ethical corporate governance practices inspire in companies the necessary corporate citizenship, vision, processes, and structures to make decisions that guarantee longer-term sustainability. Particularly in these uncertain times, we need companies that can be profitable as well as achieving environmental, social, and economic value for society. Therefore a strong recommendation to have Corporate Governance rating to be made mandatory for listed companies.

Endorsing Jim Jones views, as he rightly says ‘Corporate governance is not something that is put in place and then left. Ensuring its effectiveness depends on regular review, preferably regular independent review. And, in the end that comes down to the shareholders. Outside assessment and self-assessment need to be regular events. "- (Business Day)

Bibliography

Arthur Levitt, www.corporate-governance.co.za/.../CorporateGovernanceQuotes/

Astrid Franchiska Kowlessar , The Sustainable Corporate Governanace Model : New Theory and Implementation, Jan 7th 2010, http://www.developmentcrossing.com/profiles/blogs/the-sustainable-corporate

Cadbury, A. (1992), The Financial Aspects of Corporate Governance, (known as the Cadbury Code), Retrieved April 9, 2007, http://www.ecgi.org/codes/documents/cadbury.pdf.

Christian Strenger (Jan 2004), The corporate Governance Score card: A tool for the implementation of CG , Corporate Governance Volume 12, Blackwell publishing.

Colin Boyd (1996) , Ethics & Corporate Governance –The issues raised by the Cadbury Report in the United Kingdom , Journal of Business Ethics , pg 167 – 182

Corporate Governance: The Foundation for Corporate Citizenship and Sustainable Businesses; UNGC Brochure.

Eugene Arthur (1987), The Ethics of Corporate Governance, Journal of Business Ethics (pg 59 -70)

Friedman, M (1988) 'The Social Responsibility of Business is to Increase its Profits', The New York Times Magazine, September 13, 1970. Copyright @ 1970 by The New York Times Company

Donaldson, T. & Werhane, P. (eds.) *Ethical Issues in Business: A Philosophical Approach.* Prentice-Hall; Englewood Cliffs, NJ.

Guidance on good practices in Corporate governance Disclosure, United nations, Newyork and Geneva, 2006, www.unctad.org/en/docs/iteteb20063_en.pdf

Helen Haugh, Alka Talwar, 'How Do Corporations Embed Sustainability Across the Organization? Academy of Management Learning & Education, 2010, Vol. 9, No. 3, 384–396.

Independent Director Code, trade.gov/.../adobe/Independent%20Director%20Code Final eng.pdf

J.J. Irani, Subir Rana, Suresh Prabhu, 'Corporate Governance, Three views; Vikalpa, Volume30, No 4, Oct –Dec-2005.

Live mint.com (7th Jan 2009), www.livemint.com

Llopis,Gonsalez & Gasco, Ethics Culture and Corporate Governance , *w.slideshare.net/.../ethics-culture-corporate-governance* –

Norberg (2008), The ethics of Corporate Governance ,Journal of General Management , Vol 33, pg 35-52

Organization for Economic Cooperation and Development, OECD Principles of Corporate Governance, www.oecd.org/.

Parrett (2003), Corporate Ethics and Corporate Governance, The Corporate Board, July/ August, pg 1-5

Raina Azmi (2006), Business Ethics as Competitive Advantage for Companies in the Globalization Era. Http; // ssm.com// abstract

Rajana Kumar (2007); Circular No 38/10/07, Corporate Governance and Ethics – Challenges on imperatives, http //www.cvc.nic.in

Rajesh Chakrabarti, Corporate Governance in India – Evolution and Challenges, Jan 2005,
www. unpan1.un.org/intradoc/groups/public/.../UNPAN023826.pdf

Ronald Berenbein (2004), Giving Ethics operational meaning in Corporate Governance, Address at a conference delivered at Institut Aspen France

Scott Fleming[a]; Mike McNamee: The ethics of corporate governance, Public Management Review, Volume 7, Issue 1 March 2005 , pages 135 – 144