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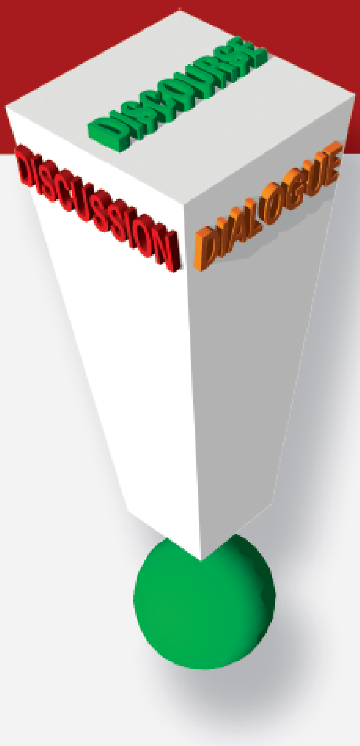

3D...
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Theme:

Business Ethics and Corporate Governance

Guest Editor

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Ethical Foundations of Corporate Governance

Farida Virani *Professor for HRM and Behavioural Sciences at Mumbai Education Trust's School of Management, Mumbai 400050. E-mail:* dr.faridaavirani@gmail.com

The purpose of this rather short contribution is to argue that the success of corporate governance is determined by the ethics and the values of the stakeholders. Furthermore, that the days of corporate governance being a set of regulations to be monitored by a set of regulators is passé. Corporate governance is no longer merely a matter of compliance but a potent instrument of sustainable development of the corporate.

Maria Ramos (CEO: Transnet) has almost prophetically said *Governance is the process whereby people in power make decisions that create, destroy or maintain social systems.* 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. Enron, the Houston, Texas based energy giant, shocked the business world with both the scale and age of their unethical and illegal operations.

The Enron scandal, revealed in October 2001, eventually led to the bankruptcy of the Enron Corporation, an American energy company based in Houston, Texas, and the dissolution of Arthur Andersen, which was one of the five largest audit and accountancy partnerships in the world. In addition to being the largest bankruptcy reorganization in American history at that time, Enron undoubtedly was the biggest audit failure. On paper, Enron had a model board of directors comprising predominantly outsiders with significant ownership stakes and a talented audit committee. Ironically, in 2000 in a corporate review conducted about the best corporate boards, Enron was listed among its top five boards.

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.

Businesses everywhere in the world have been subject to an increasing number of external and internal influences that have redefined its role. The mantra of corporate management of the past was maximizing `shareholder value'. It's 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 lay person's perspective, the pertinent among them are; what is Corporate Governance? Why has Ethical Corporate Governance come to the forefront in today's times? Does it make business sense to invest in a meaningful, effective and efficient Corporate Governance structure? What can be done to enhance the ethical dimensions in the Corporate Boards

1. Corporate Governance

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 is there to encourage the efficient use of resources and equally to require accountability for the stewardship of these resources. The aim is to align as nearly as possible the interests of individuals, corporations, and society."

According to the Organization for Economic Co-operation and Development ("OECD"), "Corporate Governance deals with the rights and responsibilities of a company's management, its board, shareholders and various stakeholders." The "OECD Principles of Corporate Governance" focus on governance problems that result from the conflicts of interest due to separation of ownership and control.

The five principles are as follows:

I) The rights of shareholders;
II) The equitable treatment of shareholders;
III) The role of stakeholders;
IV) Disclosure and transparency and;
V) The responsibilities of the board;

Arthur Levitt, former chairman of the US Securities & Exchange Commission stated, "If a country does not have a reputation for strong 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." Hence a strong and ethical Corporate Governance structure is the buzz word in the business circles today.

Let's understand its benefits from different stakeholder's perspective.

1.1. The Benefits to Companies

Compliance with the ethical Corporate Governance principles can benefit the owners and managers of companies and increase transparency and disclosure

By;

- Improving access to capital and financial markets;
- Helping survive in an increasingly competitive environment through mergers, acquisitions, partnerships, and risk reduction through asset diversification;
- Leading to a better system of internal control, thus leading to greater accountability and better profit margins.
- Paving the way for possible future growth, diversification, or a sale, including the ability to attract equity investors – nationally and from abroad – as well as reduce the cost of loans/credit for corporations.
- Seeking new funds. Organizations often find themselves obliged to undertake serious Corporate Governance reforms at a high cost, upon the demand of outsiders, often in a time of crisis. When the foundations are already in place investors and potential partners have more confidence in investing in or expanding the company's operations.

1.2. The Benefits to Shareholders

By;

- Providing the proper incentives for the Board and Management to pursue objectives that are in the interest of the company and shareholders, as well as facilitate effective monitoring.
- Providing shareholders with greater security on their investment.
- Ensuring that shareholders are sufficiently informed on decisions concerning fundamental issues like amendments of statutes or articles of incorporation, sale of assets, etc.

1.3. The Benefits to the National Economy

By;

- Playing a role in increasing the corporate value of company. Empirical evidence and research conducted in recent year's supports the proposition that, it pays to have Ethical Corporate Governance. It was found that most of the global institutional investors are willing to pay a premium for the shares of a well-governed company over one considered poorly governed but with a comparable financial record.
- 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.

2. Corporate Governance the Indian Perspective

It was in the 1970's that Milton Friedman famously argued that 'the only responsibility of business was to make a profit'. Such clarity of moral purpose arguably took place against the backdrop of an assumed division of responsibility within the confines of the nation state, such that business should be free to pursue purely economic objectives, since the Government and other institutions could be trusted to have regard to wider ethical concerns, including the legal framework within which businesses operated. Perhaps, globalization has cracked this comfortable ethical division of labor. The retreat of the Government from its welfare role under the combined pressures of fiscal crisis and the threats, real or imagined of globalization, means that we can no longer count on this source of protection (Beck 2000). Part of the growth of interest in Ethics and Corporate Governance can perhaps be traced then to these institutional shifts, and the concomitant recognition of the power and relative autonomy of the large trans-national corporation.

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 soft 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 time that, the Indian companies realize that, 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. As discussed earlier, studies in India and abroad show that markets and investors take notice of ethical and well managed companies respond positively to them and reward such companies with higher valuations. A common feature is that they have systems in place, which allow sufficient freedom to Board and Management to take decisions towards progress and to innovate, while remaining within the framework of effective accountability. In other words they have a good system of Corporate Governance.

Strong Corporate Governance is indispensable to resilient and vibrant capital markets and is an important instrument of investor protection. 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 ends 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, rather than be reactive and operate in a compliance mode only. Therefore the need of the hour is strong ethical corporate culture and leadership.

3. Building a Corporate Culture for Ethical Corporate Governance

Ethics is primarily a communal, collective enterprise, not a solitary one. Business organizations do not operate in a vacuum but rather are plunged in a universe of relationships with multiple stakeholders. Ethics are understood as the means by which individuals come to construe, decipher, and act upon themselves in relation to the true and false, the permitted and forbidden, the desirable and the undesirable.' (Rose:1992: 144). As defined by Wallace et al. 1999, 'Ethics may be thought of as a form of moral philosophy – the systematic study of moral rules, principles, obligations, agreements, values and norms'.

In, 'Political Savvy - Systematic Approaches to Leadership behind the Scenes', the author enlists numerous reason why Ethics is Power;

Ethics is Power; because for people who operate ethically their word is their bond. Time consuming and costly written agreements aren't needed. People who operate ethically, there are no hidden agendas to worry about. It fosters the development of one of the most crucial success elements for organizations - trust. Those known to operate ethically are preferred team members revered as even equal to and sometimes greater than technical competence. It increases one's reputation in the firm, a key to the amount of informal influence and power they possess in the eyes of others.

Ethics is Power; because bosses who believe their subordinates are ethical worry less that they will be negatively surprised by something wrong in their unit. They know the person will tell them if something is going wrong that could embarrass the boss in the organization. Often the result is a boss who is willing to delegate more responsibility to an ethical person, other factors being equal. This can give the ethical person more responsibility and influence. Ethical people are less likely to spend precious energy in internal turf battles, both personally and departmentally. This can free up an enormous amount of energy for task accomplishment which versus internal friction. It thus empowers teams and organizations to better serve customers and operate more efficiently. The result can be greater power and influence in the market place.

Ethics is Power; because operating ethically can increase personal self esteem. Those with high self esteem often have high confidence which can make them more powerful and influential with others than those with low self esteem. Those higher in the organization are more likely to listen to someone they know to be ethical versus someone who they believe are trying to advance personal versus organizational agendas. Ethical environments are more likely to bring out peoples' personal best instead of their personal worst - often the result of unethical environments. When ordinary people are functioning together at their personal best they are often capable of extraordinary performance.

Business ethics could be managed to gain a competitive advantage, which is corporate ethics. Business ethics has an external emphasis. Business ethics considers the gap between the corporation's ethical behavior and the market place's perception of the corporation's ethics in its business operations. Corporate ethics, on the other hand, has an internal emphasis and this could be well managed toward a unique competitive advantage as anything related to people (corporate ethics through people) is very difficult to imitate and this raises the chances of achieving a sustainable competitive advantage.

Operation of implementation of the Corporate Ethical Culture hinges on the evolving characters of the organization and individuals. The focus is on individuals, teams and organizations as whole. "Organizational culture is a set of values, symbols and rituals shared by the members of a specific organization, which describe the way things are done in order to solve managerial problems, both internal ones and those related to clients, suppliers and the business environment." Llopis, Gonzalez & Gasco. Ethical deficit occurs when the character of individuals in an organization and the corporate character are both diverging from the standard ethical values.

Building an ethical organization culture requires several aspects to be put into proper place.

The members of the organization should share a common set of: Beliefs, Values and Practices. The need is to create a Leadership and Governance framework by developing a core value set including;

- Reputational values – trustworthiness, credibility, reliability, responsibility.
- Hyper- norms – honesty, fairness, compassion, integrity, predictability.
- Ethical decision making criteria – stakeholder impact analysis and constructing a values desirability framework.

Creating effective guidance communications which should include;

- Mission statement - short, inspiring, focused on key values.
- Code of conduct and ethics - A blueprint for developing a culture of values in an organization which would;
    - Incorporate core values and cover important issues needing guidance.
    - Choose orientation – integrity or values-based vs. compliance based, or a combination approach.
    - Use input from all levels using feedback sessions and gap analysis.

Development of commitment and understand-ing through training and ethics workshops.

- Reinforcement and compliances through ;
    - Commitment of leaders, both top management and the corporate board members.
    - Periodic review the code of ethics & criteria, tools, and processes. Recognition, job descriptions and reward systems.
    - Whistle-blower anonymity and protection.
    - Rapid & fair investigation and confidentiality of findings.

Creating an Ethical Culture in the organization would go a long way to practice Ethical Governance as it would be engraved in the DNA of the organization.

Conclusions:

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. 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. Therefore a strong recommendation to have Corporate Governance rating to be made mandatory for listed companies.

A clear understanding of the basic values which preside over Corporate Governance and their clear articulation in a proper code backed by well established structures and traditions like the ethics committee and audit committee may be the best indemnity for good Corporate Governance. It is not enough to exhort managers and directors to be ethical. First, a consensus needs to be reached concerning what it means to be ethical in business. Perhaps the most important challenge we face towards better Corporate Governance is the outlook of the people and the organizational culture. A Corporate culture of ethics and values could go a long way in creating a competitive sustainable edge for any organization. Building an ethical organization culture requires several aspects to be put into proper place. It requires clearly defining the core values of the organization, selecting appropriate personnel, reinforcing and rewarding ethical behavior and keeping checks on unethical behavior.

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.

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)

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