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Principles of Corporate Governance and Ethics for Sustainable Business

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ABSTRACT: *This theoretical paper examines the importance of corporate governance and business ethics that impact organizations and individuals. In the aftermath of the public embarrassment of corporate malfeasance, organizations should underpin their policies and regulations to overcome numerous ethical issues and to ensure the well-being of all. Further, corporate governance is concerned with the ownership, control and accountability of organizations, and how the corporate pursuit of economic objectives relates to a number of wider ethical and societal considerations. Thus, this paper presents an adoption of proper governance practices and business ethics standards, and discusses the importance of such an approach in analyzing and understanding corporate governance practices. Many studies have discovered that an integrated approach towards corporate governance and business ethics should help organizations implement high standards of ethical behavior throughout the organization. In general, the prominence of such a holistic approach, by integrating several components, is the precondition of better understanding of corporate governance practices and procedures to enhance ethical behavior in organizations.*
KEYWORDS: *Business ethics, corporate governance*

I. INTRODUCTION

Phrases such as ‘corporate governance’ and ‘business ethics’ have become a major discussion topic over the past decade (Nakano, 2007). Corporate governance and business ethics have become a key factor influencing investment decisions and determining the flows of capital worldwide (Sullivan & Shkolnikov, 2006). In a critical development, good corporate governance and high ethical standards are essential for corporate long-term success (Bolman & Deal, 2008; Kim *et al.,* 2010; Robbins *et al.,* 2010). It strengthens the application and relevancy of an endeavor whether it is undertaken at the firm level or on a global scale (Wieland, 2005). Likewise, differing legal systems (Judge *et al.,* 2008), levels of national competitiveness (Millar *et al.,* 2005), and responsiveness to corruption (Ng, 2006) have all been displayed to affect a corporate governance quality. Moreover, the effective management of the relationships among the many stakeholders involved in the organization, and the attainment of its goals require that ethical standards be set, monitored and maintained. The rights of employees, suppliers, customers, and the community at large cannot in the long term be protected and ensured if the firm’s directors and executives act, and allow others to act, in ways that are less than ethical (Terblanche *et al.,* 2008).

Since the beginning of the 21st century, there has been a proliferation of interest in corporate governance and business ethics. It is a period characterized by both an increasingly globalized business world and a cascade of corporate corruption and fraud in both developed and developing countries (Gold & Dienhart, 2007). With this interest, it can relatively be associated with a growing number of scandals such as financial failures of Enron, WorldCom, Shell, Arthur Anderson (Accounting Firm) in the United States (West, 2009), Insurance and Pharmaceuticals companies in Australia (Bonn & Fisher, 2005). There has also been a corporate environmental scandal involving British Petroleum (BBC News, 2010). Further, corporate misconduct that includes: a theft in the employees’ pension fund, and bribery and corruption (Saidi, 2004), and all these have highlighted the need for organizations to impose and re-examine the role of certain corporate governance approaches in their day to day operations. The impact direction of such practices of corporate governance is found by Charbaji (2009) in both public and private organizations.

Mizuo (1998) asserts that “the string of corporate scandals also leads to the conclusion that fairness is an essential requirement for all corporate activities. When reflecting on our changing times, one sees that the business ethics of each company as well as the implementation of those ethics at all company levels are prerequisites for securing the desired atmosphere of fairness (Takahashi, 1995). This paper presents an adoption of proper governance practices and business ethics standards. In general, this paper also discusses the importance of such an approach in analyzing and understanding corporate governance practices in organizations.

II. CORPORATE GOVERNANCE IN ORGANIZATIONS

Given the above examples of corporate crises and failures and also managerial misconduct, the prominence of corporate governance practices has risen significantly. In academic journals, much attention in the papers has emphasized on corporate governance models (Jacoby, 2000; Maignan & Ferrell, 2003), governance reforms (Westphal & Zajac, 1998) board behavior and effectiveness (Kose & Senbet, 1998) and executive compensation (Conyon and Schwalbach, 2000). A growing body of literature has investigated governance issues from the perspective of stakeholders (Frooman, 1999; Hillman *et al.,* 2001). For instance, after the financial scandals of Enron, Worldcom, and Global Crossing, the relationship between companies and their external auditors was revealed to be largely to blame, prompting the U.S. Congress to agree to reform the New York Stock Exchange (NYSE) Listing Rules (Mallin, 2007). As Monks and Minow (2004) remark in their research, corporate governance is surfacing as a more and more critical domain of modern management.

In a phenomenal growth of corporate governance, social power and influence of organizations are equally contributed to taking responsibility for balancing their own interests. According to the Cadbury report (1992) in London, corporate governance is as "the system by which organizations are directed and controlled". It is geared toward ensuring that organizations take responsibility for directing and controlling their affairs in a manner that is reasonable to their stakeholders (Rossouw, 2005; Venkatachalam & Patwardhan, 2011). Corporate governance deals with the ways in which suppliers of finance to companies assure themselves of getting a return on investment (Shleifer & Vishny, 1997). La Porta *et al.* (2000) refers it as a set of mechanisms through which outside investors protect themselves against expropriation by managers and controlling shareholders. Its guidelines are the mechanism of a company to determine which should diminish agency costs and better align the interests of boards and the suppliers of capital (Picou & Rubach, 2006). Gillan and Starks (1998) view corporate governance as the system of laws, rules, and factors that control operations of an organization. These norms and laws have shaped the relations among boards of directors, shareholders, and managers as well as to resolve agency conflicts (Gill, 2008). Some corporate governance problems, as for example CEO's almightiness, Board of Director competencies, and shareholders' interests become important only when some organization gets into trouble. In periods of glory and prosperity, rarely anyone thinks about these issues (Hebbie & Ramaswamy, 2005).

Corporate governance structures or mechanisms have enjoyed unprecedented attention around the world. There is a general acknowledgement for its prominence. This acceptance is very context-specific. In some context, its prominence was driven by the agency problem and investor activism (Rossouw, 2002), whilst in others it was driven by the desire to attract foreign investment and to gain national and international legitimacy (Chernoff, 1999). Litan *et al.* (2002) stress that corporate governance is important because it is part of the institutional infrastructure (laws, regulations, institutions and enforcement mechanisms) underlying sound economic performance. The FDK Group (2008) believes that well-established corporate governance will enhance the healthiness and the fairness and transparency of the organization. Drew *et al.'s* (2006) five elements of corporate governance to manage strategic risk, as shown in Figure 1, illustrates how each element positively reinforces the others and strengthens strategic risk management. After engaging in an examination process, shareholders can map organizational challenges against these elements, identify areas in need of improvement, and plan change management programs. Superior risk management programs and stronger firm governance capabilities result.

Figure 1: Five elements of corporate governance to manage strategic risk
Source: Drew *et al.* (2006)

In the context of inclusive development, organizations should continuously refocus their attention on shareholder value to survive (Brickley *et al.,* 2003). At the same time, they should adopt a holistic approach in order to comprehend the broad variety of variables of corporate governance and analyze their relationship in a consistent frame (Hardi & Buti (2012). This approach has already been recognized in the research on corporate governance either directly (Filatotchev & Boyd, 2009; Young & Thyil, 2008) or indirectly by a systematic perspective emphasizing the "consistent whole" (Carver, 2007), by the analysis of the plurality of corporate governance logics (Heugens & Otten, 2007) and a multi-level, multi-dimensional framework to discuss the diffusion, the content a practical impact of corporate governance (Aguilera & Cuervo-Cazurra, 2009), or by a comparative analysis of regions and perspectives (Aguilera *et al.,* 2006; Zattoni & Cuomo, 2008). An understanding of corporate governance control mechanisms helps to reduce agency problems, and improves financial performance and profit-optimization in the organization.

III. BUSINESS ETHICS WITHIN CORPORATE GOVERNANCE CONTEXT

Business ethics are a kind of applied ethics. It can be defined as the discipline dealing with moral duties and ethical norms to business. It contains the principles and standards that guide behavior in the conduct of business. Businesses must balance their desire to maximize profits against the needs of the stakeholder. The various ethical philosophies which help in explaining ethics and its vitality in business are under the heads of deontological theory, teleology theory, relativism, enlightened egoism, fairness, justice, utilitarianism and virtual justice theory (Mahajan, 2011). For Sylph (2009) ethics, as standards of society, do not exist in a vacuum but have to be evaluated with reference to accepted thresholds, actions, and feelings. Golja and Paulisic (2010) explained in his research, that business ethics is a function of culture, since the cultural evolution in the business environment will affect what are acceptable and unacceptable business activities and management principles in the marketplace and in the society, and as time influences culture because culture evolves over time, business ethics is a function of time. It is a matter of developing good habits and it doesn't happen overnight. It happens through repetition and a long process of development.

According to Mahdavi (2011) the importance of ethics in the business world is superlative and global. Ethical issues arise on a daily basis which may create an important burden to organizations and end-consumers. Nowadays, the need for appropriate ethical behavior within organizations has become essential to avoid possible litigations. The recent expansion of global business and fall of trade barriers worldwide has further underlined the interest in the topics of ethical behavior and social responsibility. Many scholars believe that human rights and environmental conservation are gaining increasing more recognition in both academic and commercial settings (Jones, 1991). After a recent exposure of ethics scandals that have harmed millions of employees and investors, and sent shock waves throughout the business world, various organizations now are more prepared to engage with ethics as part of their corporate governance reform. Many parties interested in business activities have begun looking more closely at how morally organizations are supposed to behave in their operations. They start to manage their ethics more actively, through ethics officers, ethics communication systems, and ethics training programs (De George, 2010). Some organizations emphasize the improvement of transparency and accountability by establishing a code of conduct (Demise, 2005).

Kleine & Von Hauff (2009) asserts that those ethical issues are usually debated in terms of corporate governance, environmental degradation and global warming, corporate social responsibility, and corporate conscience. In a business ethics management, organizations now have formal ethics or legal compliance programs. In 1991 the U.S. Sentencing Commission created sentencing guidelines for organizations convicted of federal crimes. The guidelines removed judicial discretion and required convicted organizations to pay restitution and substantial fines depending upon whether the organization turns itself on, cooperates with authorities, and whether it has established a legal compliance program that meets requirements for due diligence and effectiveness. These formal programs generally include the following key elements: written standards of conduct that are communicated and disseminated to all employees, ethics training, ethics advice lines and offices, and systems for anonymous reporting of misconduct (Trevino & Brown, 2004).

It was suggested that formal ethics and legal compliance program can have a positive impact. For example, the Ethics Resource Center's National Business Ethics Survey in USA, revealed that in organizations with all program elements there was a greater likelihood (78 percent) that employees would report observed misconduct to management. Moreover, when organizations have a strong ethical tone at the top, employees will collectively work to succeed through honest effort to deliver value to customers and help the company earn a profit within a rule (Ethical Resource Center, 2010). It is paramount to examine in this paper the relationship of corporate governance with business ethics, and their link with different normative theories namely: stockholder theory, shareholder theory, social contract theory, and mission statement for sustainable business.

IV. INTERRELATIONSHIP BETWEEN CORPORATE GOVERNANCE AND BUSINESS ETHICS

Corporate governance and business ethics are two crucial factors that directly impact the whole organizations and cycle of operations. The responsibilities of an organization are not only economic but society and increasingly political namely the government. Maintaining a proper perspective on this dimension is essential for the continued existence of the organization. It is no uncertainty a multifaceted job. Many organizations have confidence in adopting the best practices in the area of corporate governance. Corporate governance is the internal system of organizations to protect stakeholders' investment. Business ethics deals with the linkage between business goals and approaches to specifically human ends (Tran, 2008). It denotes the special responsibilities which a person and a citizen consents to when he becomes a part of the business world. The relationship between governance and ethics emanates from managers (agents) or organization's owner (principal), who create mechanisms to align the agents' interests with their own (Machold *et al.,* 2008).

Business ethics typically constitute a substantive normative theory. Hasnas (1998) sketches clearly that there are three major theories of normative business ethics, namely, stockholder theory, stakeholder theory, and social contract theory which are particularly relevant in this context (Laudon & Laudon, 2009). The stockholder theory suggests that managers should resolve ethical problems by taking actions that enhances long-term shareholder value without violating the law or engaging in fraud or deception. Under the stakeholder theory of ethics, managers should resolve ethical problems by balancing stakeholder interests without violating the rights of any stakeholder. Although wide ranging, this connection between these factors is often stronger, as recent changes in corporate governance include now any individual who is affected by the organization. This connection ensures that everyone receives equal or fair treatment when dealing with the business. Increasingly, stakeholder theory is seen as a credible alternative to stockholder theory, or indeed labeled its intellectual successor (Freeman, 1994). Yet, despite the differences in focus and scope, stockholder and stakeholder theories share commonalities in their reasoning which is underpinned by sharing normative basis.

Finally, the social contract theory argues that managers should strive to increase social welfare above what it would be in the absence of the existence of corporations without violating the basic principles of justice (Bose, 2012). Shareholders may be less willing to invest money into a company that follows this ethical theory, as shareholders may lose money to causes or other benefits that are outside of the company's normal operating context. To make investors fully aware of the company's social contract theory of ethics, business owners, executives and board members will often include this information in the corporate governance. Another, mission statements also increasingly denote to corporate governance and business ethics. It focuses more on a social aspect of the operations rather than a profit motive to repay shareholders. In these types of companies, shareholders will invest in the company because they believe in the company and desire to see the company succeed in its social mission. The relationship was intensified through the vast amount of press articles. Organizations used different channels such as conferences, books, and business press to disseminate such concepts (Scarbrough, 2003; Rynes *et al.,* 2007). These diverse channels decode the concepts to their corresponding audiences and increase to the popularization of the concepts.

Despite the prominence of the topic and an increasing demand for research, the correlation between corporate governance and business ethics has always been analyzed (Wieland, 2001). Even in advanced market economies, there is a great deal of disagreement on how good or bad the existing mechanisms are (Shleifer & Vishny, 1997). Researchers and practitioners gave evidence of overlapping terminology and cross-connections between corporate governance and business ethics (Rudolph, 2005). Painter-Morland (2006) conceived corporate governance and business ethics are highly interrelated and dependent upon one another. Most of the emerging market research has centered on various factors that are related to firm valuation such as corporate finance and social performance, corporate valuation, the level of disclosure, and ethical reporting (Pae & Choi, 2011). However, little has examined the relationship between corporate governance and business ethics (Bonn & Fisher, 2005).

From a corporate governance perspective, business ethics are the so-called "buttoning up of a company's collar and the straightening of its tie"; that is these are regulations concerning employee behavior and conceptual thinking, rules that make it clear that "good is good, and bad is bad" (Mizuo, 1998). Similarly, "corporate governance" should include the function of making determinations regarding company behavior, the function of adjusting and fine-tuning the relative relationship with stakeholders, and the function of monitoring management activities and results (Fukao & Morita, 1997). Pea and Choi's (2011) development of conceptual models, as shown in Figure 2, depicts two main lines of thought regarding the relationship of corporate governance with business ethics: "good management" and "slack resource". According to "good management" theory, corporate ethical environment is positively linked to the quality of corporate governance in a reciprocal manner. Strong corporate culture enhances the quality of corporate governance (Diacon & Ennew, 1996) and more compressive corporate governance, in turn, stimulates the ethical environment in an organization. High quality corporate governance then leads to better management and provision of high quality information, which

reduces agency problems and firm-specific risk, promotes both ethical commitment and corporate social performance (Jamali *et al.,* 2008; Money & Schepers, 2007). The resulting enhancement of market reputation (Neville et al., 2005) improves the chance to recruit more capable employees. Even though good corporate governance may be important in achieving better future operating performance, it is not apparent that the benefits of good corporate governance will manifest in a company's contemporaneous financial performance.

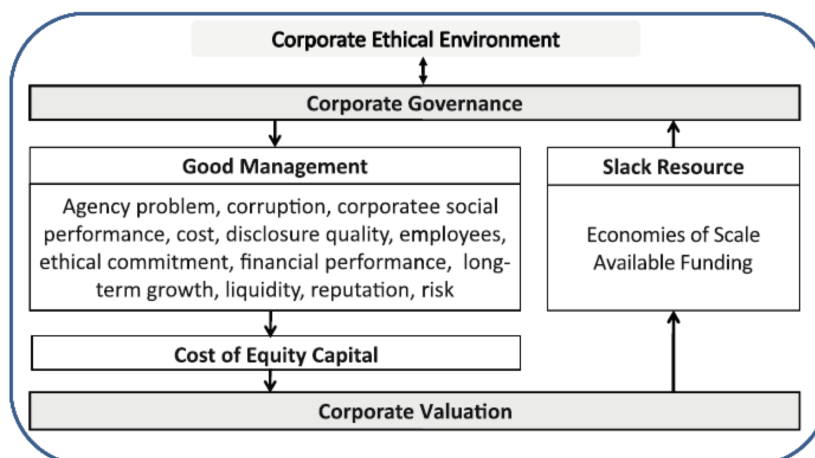

Figure 2: The relationships between corporate and business ethics, and their value implications
Source: Pae and Choi (2011)

In corporate relationships, it seems reasonable to expect that operating organizations should serve different stakeholders in an ethical manner. A corporation should engage with its internal and external stakeholders to determine its current ethical reputation amongst the stakeholders, as well as what their ethical expectations are of that organization (Rossouw, 2010). Thus, under the corporate governance requirements, a corporation should account for its ethical performance and duly report it to relevant stakeholders. According to Khomba and Vermaak (2012), the discussion of the business ethics dimensions is varied, depending largely on social and economic elements surrounding the organizations concerned. The view that prevails depends on the roles that organizations are supposed to play internally and in society in general. In micro-ethics, the central question is the fairness of the organizational choice of an economic system and also the ethical merit of the key elements of such a system. Essentially, these key elements comprise the profit motive, private property, the limited liability of corporations, competition, and free markets (Du Plessis, 2010).

V. CONCLUSION

The present economic growth of the global market is governed by technologies with a high speed of change. The emergence of corporate governance practices offers valuable insights into the mechanisms of institutional transformation. It ensures that the long-term strategic objectives and plans are established and that the proper management structure is in place. In the wake of a series of managerial misconduct and financial scandals, a growing number of cogent policies and regulations will develop more comprehensive corporate governance to protect and reduce financial risks of stakeholders' investments. To maximize the investment of the shareholders, who risk their capital in the organization, corporate governance mechanisms exist to provide accurate information to shareholders so that they may determine whether to continue their contracts with management (Wheeler, 2002).

Corporate governance is the exercise of power over and responsibility for corporate entities, and Mallin (2002) places responsibility as an element of ethics or care beside mechanism of control through laws and rules as reflected in a number of definitions. The importance of corporate governance is emphasized by the assumption that in a global capitalist market framework, compatibility with developed markets is necessary (Dallago & Iwasaki, 2007). Therefore, corporate governance should be seen as a framework for sustainable growth at all levels of the organization. In this conceptual paper, organizations supported the dominance of basic complementary concepts in the business and society field, namely: corporate governance and business ethics. These two important elements are positioned in terms of the prevailing business and society themes. In a corporate perspective, it implies that organizations cannot restrict their actions and mechanisms without addressing the concepts simultaneously. A holistic approach may help organizations analyze the numerous aspects of corporate governance and business ethics for better economic development and sustainability as well as retaining a talented workforce.

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