BUSINESS ETHICS AND CORPORATE GOVERNANCE

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LEARNING OBJECTIVES

Business Ethics and Corporate Governance aims at providing learners knowledge, guidelines, and tools to address ethical and governance issues in their careers. Although differences exist, we embrace common values. In this course, learners will gain a thorough understanding of key ethical theories and their influence on the formation of business ethics.. Learners will be able to identify and analyze business ethical issues in a more informative manner.

Learners will understand the meaning of corporate governance, explore governance models and theories in global settings, and distinguish between the advantages and disadvantages of these models. Through case studies and illustrations, learners will receive an overview of the governance principles and frameworks proposed by international organizations and their applications in various countries and organizations. Learners will gain a fundamental understanding of how private owners and states control enterprises and develop an understanding of the methods and mechanisms of corporate governance.

In this course, learners will gain practical knowledge on why ethical governance is critical and the link between business ethics and corporate governance. Learners will expand their knowledge in ethical behavior from global, enterprise, and individual perspectives. Throughout the course, case studies demonstrate the applications of ethical corporate governance. Learners are encouraged to apply the course material in developing humane and society-oriented policies, initiatives, and business solutions for enterprises and the community at large.

UNIT 1

INTRODUCTION TO BUSINESS ETHICS AND CORPORATE GOVERNANCE

STUDY GOALS

On completion of this unit, you will have learned …

- what business ethics is and how it fits in the framework of business practices.
- key terms in the field of ethics.
- the meaning of corporate governance.
- how business ethics and corporate governance are connected when dealing with complex business agendas.

1. INTRODUCTION TO BUSINESS ETHICS AND CORPORATE GOVERNANCE

Case Study

You are tasked with promoting artificial joints manufactured by your employer, a renown medical device company. Recently, your company has developed a new hip joint that will reduce the recovery period for patients. It is also less expensive than that of the competitors. However, a small percentage of patients have reported serious infections after having a hip replacement. The company has never disclosed this side effect to the public. You feel that you may have a duty to let the patients know. However, the non-disclosure agreement you have signed with the company prevents you from doing so. What would you do?

This debate in your mind is the process of searching for ethical answers: What is the right thing to do? In some cases, the evaluation process can be difficult because the answer may not be straightforward. Frequently, our decision is not to choose right or wrong, but rather the least harmful situation from a number of unideal ones. The choice often has to do with selecting the right option among many. Which principles should you follow when facing an ethical dilemma? Understanding our ethical rationale is the key to sound ethical decision-making.

1.1 Basic Terms and Definitions in Business Ethics

Ethics
This is a branch of philosophy concerning the appropriate moral characteristics and conduct accepted by members of society and individuals.

The simplest explanation of **ethics** is “doing the right thing”. However, scholars tend to define this term from both a purely philosophical and a social contract perspective, as well as from a theoretical and a practical perspective. For example, Jalsenjak (2019) defines ethics as “one of the philosophical disciplines concerned with understanding human behavior in the context of morality” (p. 1). Ulrich (2008) considers ethics as “the accepted morals of a social group by a qualified justification of moral claims” (p. 25). In contrast, Treviño and Nelson (2017) focus on conduct. To them, ethics is the “principles, norms, and standards of conduct governing an individual or group” (p. 18). Both individual and group ethical principles impact the decision-making process. Hereafter, the simplest explanation of business ethics would be doing the right thing in business dealings. Different cultural, geographical, or industrial backgrounds exercise a great influence on a decision-maker’s judgment.

Moral
This is a philosophy or system of beliefs regarding the differentiation between right and wrong from an individual perspective.

While values are enduring beliefs and ideals that are socially enforced, **morals** concern individuals. Morals refer to personal philosophical choices, i.e., what is right and wrong in intentions, decisions, and actions. For example, your morals could be about being nonjudgmental and dependable. These morals do not conflict but coexist with your company's values regarding trustworthiness and integrity. When you practice both, you have demonstrated ethical practice in and for your company.

Conflict arises when you honor dependability, but some of your colleagues rarely inform the team when they are absent. Their actions burden other team members and ruin the team's reputation. If the manager does not address this behavior, it could be an indication that dependability is not valued in the company. Otherwise, realigning the team's morals in this aspect is necessary for the team to function effectively.

The demonstration of moral practice is called **virtue**; it "represents an acquired disposition valued as a part of an individual's character. As individuals develop socially, they come to behave in ways they consider to be moral" (Ferrell et al., 2017, p. 164). Ferrell et al. (2017) explain that virtue is "praiseworthy because it is an achievement that an individual developed through practice and commitment" (p. 164). A dependable person completes work on time. An honest person tells the truth. A generous person shares knowledge and wealth. A just person is fair to people. A prudent person would be very cautious with their actions. Here, personal ethics is practiced through the following steps: (1) we evaluate our personal moral philosophies and individual values, (2) we consider the values of the society, (3) we make a decision, and (4) we take an action.

Virtue
This is a praiseworthy demonstration of a person's morals, i.e., morals being put into practice.

Virtue is the disposition of one's morality, and **ethos** reflects an individual's attitude toward values (Grigoropoulos, 2020). Although ethos is rarely discussed in university ethics textbooks in the United States (US), it is widely discussed in artistic writing along with logos and pathos, for example, in Aristotle's *Rhetoric*. Additionally, in humanities, education, leadership, and public policy, scholars tend to argue in favor of ethos alone rather than combine it with ethics.

Ethos
This can be defined as a value-sharing experience between the parties involved.

Some scholars describe ethos as doing the right thing when no one is watching (Grigoropoulos, 2020). This echoes the notion that an ethical person is more likely to lead ethically in a business setting. Together with critical thinking, informed decision-making, and problem-solving skills and practices, ethos constitutes the conditional trait of future world leaders. In the context of education, Glazewski and Ertmer (2020) introduced the ethos of intentionality, a framework to guide culturally responsive teaching in the classroom. Their framework correlates with the call from Baumlin and Meyer (2018) "to explore ethos as a mode of cultural and embodied personal narrative" (Abstract).

For Baumlin and Meyer (2018), ethos is a type of interaction between speakers and audiences. Interacting ethically means interacting responsively and responsibly, even when such an interaction could lead to a prolonged negotiation. Used wisely, ethos could build trust. For example, Australia, Canada, New Zealand, the United Kingdom (UK), and the US have adapted social commons ethos in their policy-making (Lees-Marshment et al., 2020). The commons in question are resources, knowledge, and goods shared by society. Hence, encouraging public participation in the management of resources is an ethically sensible practice. This type of policy-making increases the likelihood of maximizing public interests and pursuing the common good. Such a democratic process presumably promotes a sense of community and humanity. It is even ethically sound because it is morally right. However, skepticism of such a practice does arise in extraordinary circumstances, such as the handling of an unexpected health crisis.

Now that we have discussed many philosophical aspects of ethics, we may ask, what about the law? Would abiding by the law be good enough for individuals as well as for businesses? The answer is that it may not be enough. While laws do regulate a part of individual and business conducts, illegal acts may not have ethical implications. Self-discipline is expected in our daily life. A good example is underage drinking, which is illegal in many countries. However, it is an ethical violation only within certain religious groups. Conversely, monitoring employees' emails and phone conversations may be considered unethical, but it does not have legal consequences as long as the company has informed employees in advance.

Ethics also has cultural and regional implications. National cultural characteristics are regularly at play in global organizations. Western countries, such as the US, Germany, and Switzerland, exhibit more competitiveness, assertiveness, and heroism; Asian countries tend to value humility in personal interaction. In leadership, the Chinese appreciate charismatic, team-oriented, and human-oriented practices. The key to this type of leadership is to maintain group harmony and interpersonal ties. In contrast, Americans endorse a transformational style. Germans favor straightforward, highly autonomous leadership with low human-orientation. Fundamentally, there is potential for conflict between Western leadership style and the values of countries in other parts of the world (Chen, 2015).

G7 countries
Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States are in this group.

Just as national cultures are different among various countries, the differences in ethical expectations and practices are also quite noticeable. The interpretation of "doing the right thing" can vary from country to country. For instance, BRIC countries (Brazil, Russia, India, and China) exhibit significant differences in ethical business practices from those of **G7 countries** (Ardichvili et al., 2010). In a survey of more than 20,000 managers and employees of large business organizations in 11 countries (including both BRIC and G7 countries), India received the highest ranking in ethical work environment, employee commitment to ethical conduct, leadership commitment to ethical conduct, and ethical business practices. Another Asian country, Japan, received the lowest ranking. The ethical priority could also differ from one culture to another (Resick et al., 2011). People in the US and Ireland value "character" as the top ethical leadership attribute while consideration and respect for others are valued above anything else in Germany and China. Deception and dishonesty are the top unethical behaviors in the US and Ireland. Germany and China have incivility at the top of their list. Such differences are potential conflicts for global corporations. How do businesses decide their priorities?

Some corporations explicitly state their values: *Badische Anilin und Soda Fabrik* (BASF) strives to provide a viable future with enhanced quality of life for everyone (BASF SE, n.d.-a); SAP commits to helping every customer become a best-run business. Together, they transform industries, grow economies, lift societies, and sustain our environment (SAP SE, n.d.). Johnson & Johnson values patients, doctors, nurses, parents, employees, communities, and shareholders, in this particular order (Johnson & Johnson, n.d.). HCL Technologies use their core values of trust, transparency, flexibility, and "employee first" to build long-term relationships with customers (HCL Technologies, n.d.). These four companies are just a few examples of organizations that have made ethics relevant to their businesses.

The **value framework** of an organization could further enhance a company's ethical practices. When they react to economic and social impact, leaders make choices regarding their business conduct according to the ethical principles they hold. Hence, virtue and business performance influence one another. That means two values—monetary and philosophical—influence the organizational decision-making process (Rossouw & Van Vuuren, 2017). These two values are categorized into the following typical organizational settings:

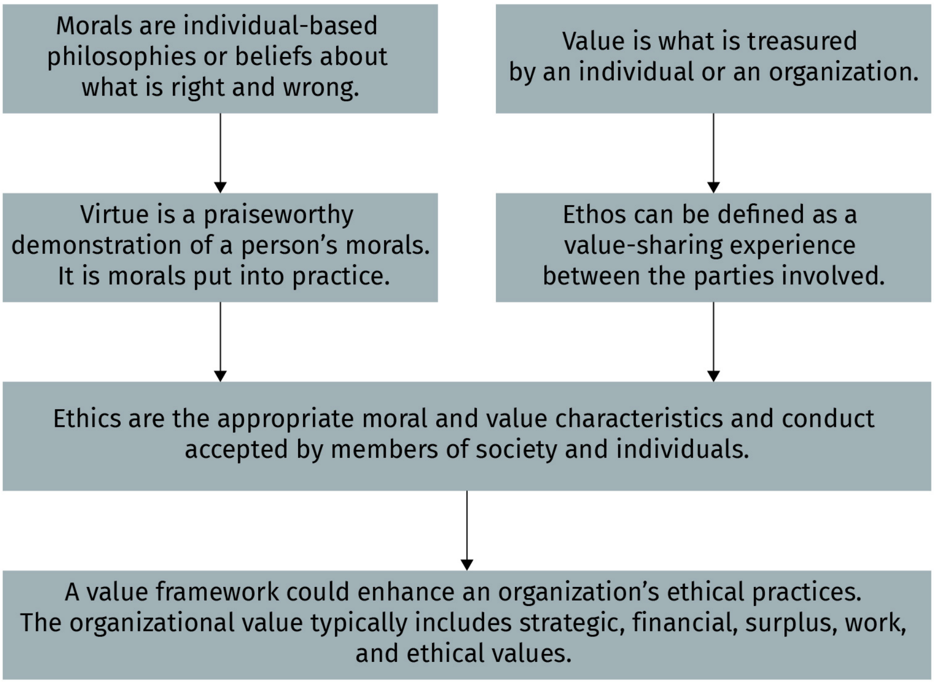
Value framework
Organizational values typically include strategic, financial, surplus, work, and ethical values.

- strategic value (the company's mission or vision statement)
- financial value (the shareholder value, economic value, and market value)
- surplus value (the difference between labor cost and the value the labor can produce)
- work value (employees' outputs meet the quality and quantity expectations in a set timeframe)
- ethical value (the expected belief and behavior of stakeholders)

The balance or the imbalance of monetary and philosophical values leads to four possible outcomes: profitable and virtuous, profitable but not virtuous, virtuous but not profitable, or neither profitable nor virtuous. There is increasing evidence that consumers reward businesses that value ethical conduct (O'Toole & Vogel, 2011).

A leader's wishful thinking is often not enough to drive the organization in the right direction. Businesses must rely on both formal and informal systems to enforce and encourage ethical practices. Formal systems are written policies and procedures, established performance management, and authorization processes. Informal systems are word-of-mouth strategies, praised conduct, and encouraged behaviors. Together, both systems form the value system and ethical foundation of the organization.

Figure 1: Ethics and Its Associated Terminologies



Source: Created on behalf of IU (2021).

Another aspect of business ethics is human rights. Human rights may appear to be beyond the corporate operational parameter. One needs to bear in mind that a business could not exist by isolating itself from society. The social, economic, political, and cultural environment can greatly impact the business success or failure in today's ecological environment. The United Nations Universal Declaration of Human Rights was published 1948 and remains perhaps the most empirical transcultural policy. It was followed by the European Convention on Human Rights (ECHR) two years later. Over two decades later, the United Nations Code of Conduct on Transnational Corporations (1972) and the Organization for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises (1976) were developed. Together, they provide guidelines for global corporations to respect and protect human rights in the region and country where they operate.

Despite this work, human rights violations still present risks for multinational corporations in terms of legislative obligations, civil litigations, business disruption, and reputation damages (Freshfields Bruckhaus Deringer LLP, 2020). Canadian and Australian mining companies have been sued for human rights violations. In 2015, a Peruvian farmer sued a German energy company for contributing to global warming and associated glacial melting close to the farmer's village by operating its coal power plants. A non-governmental organization (NGO) commenced civil proceedings against the Dutch government, arguing that it had not been doing enough to prevent climate change.

Conversely, corporations such as BASF, SAP, J&J, and HCL adopt a more positive approach to this subject. They embedd corporate citizenship into their leadership strategy, and build their wealth around the well-being of people. Good corporate citizenship can avoid hassle. It protects human rights, supports freedom, prohibits child labor and workplace discrimination, promotes environmentally friendly technologies, and works against corruption (UN Global Compact, n.d.).

1.2 Basic Terms and Definitions in Corporate Governance

Unlike the history of teaching ethics, which can be traced back to the sixth century in ancient China (the Laozi period), the practice of **corporate governance** only began in the sixteenth century without any written guidelines (Morck & Steier, 2005). In the 1970s, the question of how corporations could be trustworthy was frequently debated among scholars, regulators, and corporate stakeholders. Eventually, corporate governance appeared in the *Federal Register* (the official journal of the government of the United States) in 1976 (Cheffins, 2011). Since then, accountability has become the focal point of government regulations.

Corporate governance
The supervisory and management board uses this control and directing framework to balance the economic and social goals of an organization.

What exactly is corporate governance? Is it another synonym for business administration, management, or internal control? Among many definitions, Cadbury (1992, as cited in Mor & Browning, 2020) perhaps provides the most comprehensive framework: “Corporate governance is the system by which companies are directed and controlled” (p. 5). Cadbury (2000) further explains that “corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals” (p. 4). Because both internal and external leadership are responsible for the controls and goals of an organization, we could say that corporate governance is a control and directing function. This definition covers the spectrum of business operations. The paradigm of corporate governance goes beyond business management and administration, the latter of which focuses on running an effective and efficient enterprise. It is also distinct from the rules, procedures, law- and regulation-oriented **internal control**. Sound internal control achieves the objective of financial reporting compliance, which only constitutes a fraction of the corporate governance objectives.

Internal control
This is a process that provides reasonable assurance of the reliability of financial information.

Internal control is an essential mechanism for a business operation. Control mitigates risk, safeguards economic resources, and prevents other parties from obtaining economic benefits from these resources (International Financial Reporting Standards [IFRS] Foundation, 2018). Control is somewhat financially driven for the obvious reasons that, first, monetary assets are the most attractive and most vulnerable, and second, they are a critical indicator of a firm’s economic performance. Thus, monetary assets are subject to manipulation when a firm’s financial result is not optimal. These are the key reasons why enforcing internal control is an important accounting practice. As the American Institute of Certified Public Accountants (AICPA, 2014) explains, “internal control is a process effected by plan management and other personnel, and those charged with governance, and designed to provide reasonable assurance regarding the achievement of objectives in the reliability of financial reporting" (p. 4). Given that the failure of many companies was due to a lack of or faulty internal control, it naturally becomes one of the core elements of corporate governance. In fact, many corporate governance codes and guidelines in different countries are issued by the financial monitoring legislative agencies.

Despite different political views, countries and international organizations agree that corporate governance policies play important roles "in achieving broader economic objectives with respect to investor confidence, capital formation, and allocation" (OECD, 2015a, p. 12). Therefore, G20 member countries developed corporate governance guidelines for publicly traded, multinational corporations. G20/OECD Principles of Corporate Governance (The Principle) is the result of such a collaboration. The Principle provides voluntary guidelines for the following aspects: corporate governance framework; the responsibilities of boards; the role of stakeholders; the rights and equitable treatment of shareholders; and transparency (OECD, 2015a). It is quite obvious that accountability is cascaded down to and segregated among all **stakeholders** in the spirit of common understanding. Under the Principle, the corporate governance framework should incorporate the overall economic impacts and market integrity, be consistent with the laws and regulations, and promote transparency and integrity. The Principle stresses the importance of both stockholder, as well as stakeholder, rights and strongly encourages employee participation. The board is urged to practice due diligence and care, be fair, and apply the highest ethical standards.

Stakeholders
Individuals or groups who are affected by a company's conduct or who can affect the company are called stakeholders.

Ferrell et al. (2017) define stakeholders as "customers, investors and shareholders, employees, suppliers, government agencies, communities, and many others who have a 'stake' or claim in some aspect of a company's products, operations, markets, industry, and outcomes" (p. 31). Stakeholders have a reciprocal relationship with an enterprise. Stakeholders provide resources, products, knowledge, skills, or funds to the business, while businesses need to deliver products, services, practices, or rewards that meet expectations. Stakeholders are instrumental to the success of business operations, decision-making, and financial performance. Typically, those who have financial interests and whose participation is critical to the firm's survival are treated as primary stakeholders. Otherwise, they are referred to as secondary stakeholders. Corporate governance involves and is responsible for both types of stakeholders (Treviño & Nelson, 2017).

The G20/OECD Principles of Corporate Governance supplemental or expand country-originated corporate governance systems in both literal and practical terms. The UK Financial Reporting Council's Corporate Governance Code (2018), the Securities Market Association of Finland's Finnish Corporate Governance Code (2020), and the Association of Southeast Asian Nations (ASEAN) Corporate Governance Scorecard (The ASEAN Capital Markets Forum, 2017) are among the few policies explicitly containing the term corporate governance.

Although the latest ASEAN Scorecard is dated May 2017, the most recent assessment report that can be located is for 2015 and was issued in 2017 (Asian Development Bank, 2017). The scorecard covers all five OECD Principles with two levels of assessments. Level 1 consists of 179 items that assess the implementation of five principles, and Level 2 adds on 11 "bonus" and 22 "penalty" items. The maximum attainable score is 126 points. According to the 2015 report, 33 of the 555 publicly listed companies that participated received more than 100 points. Thailand received the best score overall among the six participating countries: Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Vietnam. The company with the highest score was from Singapore.

In contrast, the US and India rely on their existing laws and regulations to serve as a corporate governance framework. India's elaborate 2013 Companies Act regulates almost every aspect of business operations: formation, public offering practice, management and admiration, establishment of financial accounts, appointment of the directors and board, audits, bankruptcy, and recovery (Ministry of Corporate Affairs, 2013). The Sarbanes-Oxley (SOX) Act of 2002 (US Government Publishing Office, 2002) and the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) are two notable examples of US legislation. In addition to holding corporations accountable for honest financial reporting, SOX penalizes any individuals who certify fraudulent financial reports with a fine up to $5 million and imprisonment up to 20 years (US Government Publishing Office, 2002). Under the Dodd-Frank Act, whistleblowers will receive between 10 and 30 percent of the amount the government recovers from financial fraud when the original information they provide leads to the recovery of more than a million dollars (Treviño & Nelson, 2017).

In a similar vein, countries have established their own models to implement corporate governance. Three models are predominantly implemented by developed countries, and a mixture of is adapted by the emerging markets. The majority of native English-speaking countries use the Anglo-American model. German-speaking countries, the Netherlands, Belgium, and France use the German model. The Japanese model is unique to Japan (Mostepaniuk, 2017). The table below depicts the similarities and differences between these three models. Despite the structural differences, all five OECD principles are included in the governance framework.

Table 1: Corporate Governance Models

Governance activities	Anglo-American model	German model	Japanese model
Board election	Elected by shareholders	Elected by employees, labor unions (50%) Elected by shareholders (50%)	Elected by shareholders
Board structure	One-tier	Two-tier	Two-tier
Officer appointment	By the board of directors (BOD)	By the supervisory board (including bank representatives)	By the supervisory board (including the president)
Accountability	Officers to BOD	Managing board to supervisory board	BOD to shareholders and government
Operation management	Officers	Officers, managers	BOD (including CEO) and government
Responsibility	Leadership, internal control, external reporting	Independent management of operations	Management and evaluation of operational activities

Governance activities	Anglo-American model	German model	Japanese model
Other			Loan provision from financial institutions

Source: Created on behalf of IU (2021), based on Mostepaniuk (2017).

The OECD Principle mandates the disclosure of corporate governance in annual financial reports (OECD, 2019). Forty-four of the 49 global jurisdictions, including all G20, OECD, and financial stability board members, require such disclosure on a corporate level. Many countries also issue national reports on corporate governance either yearly or every two to three years. The key contents cover the corporate governance landscape and the evaluation of the practices.

According to Russell Reynolds Associates (2020), a New York-based international management consulting firm, the current trend of corporate governance emphasizes

- environmental issues, social issues, and governance (ESG). Climate change, political contributions, and human rights, especially concerning workers in supply chains, will be the focus of different forms of corporate disclosure.
- the increasing importance of corporate purpose. This concerns the expectation that corporate executives engage in social and political topics in the US and Canada. They explain that “a shift in corporate purpose from shareholder primacy to stakeholder capitalism is underway” (p. 4). In France, *raison d’être* (corporate purpose) may become a legal requirement. Spain extended its corporate governance principles to private companies in 2020. Both France and Spain are also incorporating ESG in their corporate strategies.
- corporate culture and human capital management. The authors explain that “pressures for board oversight of corporate culture and HCM (human capital management) have been reinforced in the United States by the SEC’s (US Securities and Exchange Commission) proposal for new HCM disclosure requirements” (p. 4).
- board diversity. Many companies in the UK, the US, Canada, Brazil, and Japan have intentionally increased the number of women board members. This trend is expected to grow and expand.
- investor engagement. This will also probably be a growing trend in corporate governance.

Environmental, social, and human capital issues are the main topics of corporate social responsibilities (CSR). According to Sahut et al. (2019), corporate governance is considered a “pre-requisite” of CSR. The relationships among financial compliance, governance, control, and CSR are rather complex and require further study.

1.3 The Link between Business Ethics and Corporate Governance

Why study business ethics and corporate governance together? What is the connection between these two topics? These questions have been investigated for decades, mostly from a macroeconomic and a mesosystem perspective, i.e., from a global and an organizational perspective. Although not as discussed as much as the other two in academic circles, personal conduct (or micro-level) also contributes to the successful implementation of business ethics and corporate governance.

From a macroeconomic perspective, Ulrich (2008) argued that Anglo-Saxon countries employ ethics to fix economic problems, while German-speaking countries embrace an economy based on goodness, fairness, and justice. His integrative business ethics intertwines both approaches to develop an ethical framework for a different socio-economical rationality, or reasonableness. This rationality is the “foundation of ethically integrated economic reason” (Ulrich, 2008, p. 109). Vogel (2018) agreed, stating that economic philosophy cannot appear as purely practical business ethics. Business ethics must instead be supported by socio-philosophically substantiated economic theory considerations.

From the mesosystem (organization) perspective, Steckler and Clark (2019) conceptualized the need for linking business ethics and corporate governance in an authentic way. They argue that authenticity is one of the most important characteristics of leadership. Board members should be able to speak their true (authentic) thoughts at board meetings. They are expected to draw from their own values during board discussions, deliberations, and decision-making processes. They are also expected to simultaneously evaluate the interests of all stakeholders during these processes. Rooted in good values, corporate governance can be implemented effectively.

By analyzing the relationship between corporate governance, business ethics, and corporate social responsibility (CSR), El Gammal et al. (2020) concluded that ethics mediates the audit committee component of CSR and corporate governance in the Middle Eastern and North African regions. The theory that good ethical performance enhances company value was validated in a a study of 240 large US companies (Mili et al., 2019). In contrast, evidence indicates that weak corporate governance and regulatory environments, along with financial losses, have led to corporate ethical vulnerability in 28 countries (selected from Asia, Africa, Europe, the Middle East, and North America and represented by 253 firms around the world) (Ullah et al., 2019). In conclusion, business ethics and corporate governance are correlated and influence each other on both macro and meso levels.

On the micro-level (personal conduct), a classic, unethical example is the fall of the Enron Corporation, headquartered in Houston, Texas. Once one of the world’s largest energy companies, several employees reported an internal accounting scandal to human resources and the company’s chairman in the early 2000s. None of them were taken seriously. As a matter of fact, the concerns and complaints were ignored for months until an employee disclosed the concern to the US House of Representatives Energy and Commerce Committee. Subsequently, at least nine executives were found guilty of fraud, tax evasion, insider trading, or conspiracy. The punishments ranged from heavy fines to prison time. The company went on to declare bankruptcy and 5,100 of 7,500 employees lost their jobs (Jennings, 2012).

This is just one of the many cases in which negative values, such as greed and arrogance, took priority in the decision-making process. Poor judgement on a personal level led to the fall of an enterprise. The executives ignored laws and regulations, exemplifying that "weak regulatory environment and internal corporate governance, combined with profitability warnings or losses in the preceding year, increase[d] organizational ethical vulnerability" (Ullah et al., 2019, p. 668).

Municipalities are not exempt from governance irregularities. Roughly $71 billion (1,216 billion South African rand) government procurement transactions were found missing or with incomplete documentation in South Africa during annual Auditor General audits in the 2016/2017 fiscal year (Koekemoer, 2019). In the same period, around $1.2 billion (21,243 billion rand) were classified as irregular expenditures.

Both executives and regular employees can make an impact on corporate governance, either positively or negatively. If all production workers followed safety rules, accidents, injuries, and pollution could be prevented. If all design staff considered the health and safety of the customers a priority, many casualty claims and complaints could be avoided. If materials were acquired from legitimate sources, there would not be a market for child labor.

The International Organization for Standardization (ISO) has been guiding organizations in mediating ethical and corporate governance risks since 2009. Established in 1947 and now headquartered in Geneva, Switzerland, the ISO develops and publishes international quality management standards, environmental standards, and information security management standards (ISO, n.d.-a). The organization currently has 164 national members participating in its standardization process. In 2009, the ISO published the first version Risk Management Guidelines: ISO 31000:2009. The second and most recent version is ISO 31000:2018. These guidelines incorporate human and cultural factors into their risk management principles. They hold both executives and the board of directors accountable for demonstrating leadership in risk management and governance (ISO, n.d.-b). Meanwhile, the ISO 31000:2018 assessment is an integrated process in which all levels, activities, and stakeholders of the organization are within the evaluation framework.

SUMMARY

Ethics is defined as the appropriate moral and value character and conduct accepted by members of society and individuals. Business ethics is about doing the right thing by demonstrating acceptable morals and values in business dealings. Nevertheless, "what is right" is subject to interpretation and can change in different cultures and different industries or when considered from a different ethical perspective. Similarly, values can be monetary and philosophical. Corporate governance is a control

and directing framework used by a board of directors to balance the economic and social goals of an organization. It is also concerned with holding the balance between individual and collective goals. Hence, it is tasked to balance two types of values. Corporate governance can be implemented through internal controls, legislation, corporate social responsibility, and risk management.

UNIT 2

ETHICS THEORIES

STUDY GOALS

On completion of this unit, you will have learned …

- the levels of moral development.
- the difference between normative, meta-, and applied ethics.
- the meaning of ethical theories, such as utilitarianism and deontology.
- key business ethics terminology.

2. ETHICS THEORIES

Case Study

In 2012, the catastrophic Hurricane Sandy flooded 15 northeastern US states, causing $10 billion in property damages and $10 to $30 billion in business losses (Sharp, 2012). From the end of October to early November that year, millions of households and countless businesses lost electricity. Roads were blocked by floods or fallen trees, flights were canceled, and land shipments were delayed. Most public transportation stopped. Many gas stations in New York and New Jersey were shut down due to either a lack of electricity to pump gas or a shortage of supplies. During this period, some gas stations in New Jersey even raised gas prices. Did they do the right thing?

This unit may not provide an immediate answer to this question, but will rather introduce some of the ethical theories that people and businesses have been relying on to make business decisions like this one. You will discover that judging what is right or wrong may be quite different under an ethical lens. This unit will also bring awareness to the different stages of moral consciousness development. The moral state of mind tremendously influences the ethical decision-making process. Thus, learners are encouraged to evaluate business scenarios through a different ethical lens and to be mindful of people's moral development.

2.1 Ethics Theories

Many ethical theories are currently in place to inform our practices without us even knowing it. In this section, we would like to explore some of the most important ethical theories that have influenced business practices and decision-making for centuries. We hope that studying these theories will help learners clarify their own ethical orientation and be more effective when working with others who hold different ethical beliefs.

Level of Moral Development

You may recall that ethics is defined as having the appropriate morals, values, and conducts that are accepted by members of society and individuals. Therefore, understanding the process of moral development is critical to the study of ethics theory.

Kohlberg's moral development
This is a three-level, six-stage process that is critical to our understanding of moral development.

Just like human cognitive development, the learning and development of moral consciousness takes time, experience, and practice. American psychologist Lawrence Kohlberg laid out a **moral development** process consisting of three levels and six stages. The three levels are called pre-conventional, conventional, and post-conventional; each level is comprised of two stages, which are illustrated in the table below (Ulrich, 2008; Treviño & Nelson, 2017).

Table 2: Moral Development and Examples

Levels	Stages	Examples
Pre-conventional	Stage 1: Obedience and punishment orientation	If I reveal this information, will I lose my job?
	Stage 2: Instrumental and exchange orientation	If I keep quiet will I be rewarded?
Conventional	Stage 3: Interpersonal accord	My team usually has a drink at the bar after work. I should join them if I want to be a team player.
	Stage 4: Social accord	I am a law-abiding citizen.
Post-conventional	Stage 5: Social contract and individual rights	Both women and men have the right to education.
	Stage 6: Universal ethical principles	

Source: Created on behalf of IU (2021), based on Treviño & Nelson (2017).

Ulrich (2008) described the three moral development levels in metaphorical terms: toddler, well-socialized child, teenager (stage 4.5), and mature adult. The charming metaphor reveals two undeniable facts: Moral development takes time and is associated with the societal context. If an employee is always worried about job security, would that person have the focus and energy to contribute to the well-being of society? If team cohesion is based on making a seamless fraudulent transaction, would they care about the losses of company? If a company has been dumping untreated waste chemicals in a river, would they act as responsible citizens? In a business sense, the level of moral development will lead to the level of awareness and contribution an individual or group of people could bring to the social-economic environment they live and operate in.

Ethics Theories

Let's suppose that we are all at stage four of our moral development. It is time for us to explore universal ethical theories within the context of social contract and individual rights. In this section, we will learn about prescriptive theories, i.e., what people should be doing to be ethical. Some scholars may have been employing different terms to describe the same phenomenon. This unit will use common terminology and will discuss several major theories, particularly those that often appear in the business field. Later, we will explore descriptive theories and their purpose by connecting the prescriptive theories with business ethics, i.e., applied ethics. The chart below provides a snapshot of the unit coverage.

Table 3: Ethical Theories at a Glance

Category	Normative ethics	Meta-ethics	Applied ethics
Sub-category	1. Consequential/ teleological/ utilitarianism 2. Deontology/categorical imperative 3. Virtue 4. Excursus: minimal ethics, principlism, and communitarianism 5. Natural law	1. Cognitivism 2. Non-cognitivism 3. Realism 4. Anti-realism	1. Business ethics 2. Conscience 3. Stealing 4. Killing 5. Lying

Source: Created on behalf of IU (2021).

Normative ethics

What interests normative ethical philosophers is the standard that governs people's moral behaviors. Normative ethics is an ideal, theorized ethics standard that philosophers developed through their rational thinking (Ferrell et al., 2017). As illustrated above, different philosophers tend to approach the study of this phenomenon from rather different points of view. Some of these new points include

- virtue (Aretaic) ethics theory. The meaning of virtue comes from a Latin word *vitus*, moral perfection. This ancient Western ethical theory was developed in 399 BCE. It is frequently connected with the arguments from Greek philosophers Socrates, Plato, and Aristotle (Jalsenjak, 2019; Dimmock & Fisher, 2017). The oldest Eastern ethical philosophy ever written on a similar subject, *Tao De Ching* ("the way and its power"), dates back to the sixth century BCE (Malik, 2015; Jackson, 2014). For Aristotle, the good of a person is the active exercise of their soul's faculties in conformity with excellence or virtue (Crisp, 2000). Contemporary virtue ethics tells us "what kind of a human being [we] should be in order to fulfill the need [we] have as [humans]" (Jalsenjak, 2019, p. 2). Personal character, behavior, and well-being are the key themes of this theory.
- excursus theory. Three ethical theories sum up the excursus theory: minimal ethics, principlism, and communitarianism. Although communitarianism is mostly associated with American philosophers, this theory is not widely discussed in Anglo-American countries. However, it is worth mentioning because it is the foundational value among European Union countries. These three theories embrace "pluralism, nondiscrimination, tolerance, justice, solidarity, and equality between women and men" (Frischhut, 2019, p. 34). Under the principles of "human dignity, freedom, democracy, equality, the rule of law, and respect for human rights," the EU introduced its key values regarding healthcare, i.e., "universality, access to good quality care, equity, and solidarity" (p. 34). Digitalization and non-financial sports reporting are other areas of application of those values.
- natural law theory. Natural law is not a list of rules and regulations; rather, it is a process of reasoning about what is good for humans. According to Thomas Aquinas (1225—1274), God has made plans for all. Everyone has a purpose and ought to follow these

plans. Something is good because it fulfills its purpose and plan. Ultimately, “when humans act in accordance with their purpose/function of reason, then they act according to the natural law” (Dimmock & Fisher, 2017, p. 240).

Meta-ethics

Meta-ethics focuses on how ethical study works. If we adopt the analogy of sports, meta-ethics would be a role similar to the commentator’s evaluating how an ethical theory has worked in practice (Dimmock & Fisher, 2017). The actual worth of this subject is still debated, mostly among scholars rather than practitioners.

Applied ethics

Applied ethics deals with how we should act with respect towards certain issues in our lives and in business dealings (Dimmock & Fisher, 2017). Is conscience ethical? Is stealing ethical? Is lying ethical? Applied ethics is not a stand-alone theory. It is a series of ethical theories that evolved from the application of prescriptive theories. Organizations with a different ethical philosophy could make quite different judgements and decisions, something which we will discuss further in the next unit. For example, will the answer to the case at the beginning of this unit be the same if seen from a consequential, virtue, natural law, or excursus perspective? The last thing we should also bear in mind is that the complexity of life and business environments will create uncertainty which will prove even more challenging for practitioners.

2.2 Comparison between Utilitarianism and Categorical Imperative

Two major renown normative ethical theories that have largely impacted our lives and business conduct are deontology and utilitarianism. From real life events, country regulations or regional laws, healthcare, technology, accounting, finance, and education, Kantianism and utilitarianism have been the foundations for countless pieces of legislation and practical guides.

The term utilitarianism has been used interchangeably with consequential or teleological theory by many scholars. Yet, a good number of other scholars consider utilitarianism as a popular sub-category of teleology and consequentialism (Hull, 1979; Ulrich, 2008; O’Mathuna et al., 2018; Frischhut, 2019; Jalsenjak, 2019). In this course, we will adopt this second approach.

Similarly, deontology and Kantian ethics, or the **categorical imperative**, are frequently used interchangeably. Deontology is a form of normative ethical theory. It is a duty-based ethical theory answering the question of whether a responsible person’s duty is to make a morally right decision (Jalsenjak, 2019). There are differences between deontology and Kantianism. Deontology has its cultural relevancy; the duty and norm that one ought to comply with should be appropriate for and in accordance with a specific culture setting.

Categorical imperative
This is a deontological moral theory developed by German philosopher Immanuel Kant. This theory contains three principles: the basic principle, the principle of humanity, and the principle of kingdom of ends.

One form of deontology is divine command, a religion-based ethical theory that requires followers, parishoners, or believers to perform certain spiritual duties, rituals, and rules (Hull, 1979). Kantianism does not have a religion element or any cultural aspects. Therefore, we consider the categorical imperative as a branch of deontology. This unit will guide the learners in the comparison of utilitarianism and the categorical imperative.

Kantianism or Categorical Imperative

Immanuel Kant (1724—1804) was a remarkable scholar for his revolutionary thinking in science, arts, ethics, and religion. His ideas in ethics are introduced in his books, *Metaphysics of Morals* (1797) and *Groundwork of Metaphysics of Morals* (1785) (Ulrich, 2008; Dimmock & Fisher, 2017). These works formulated the ideas of duty, i.e., things that we are required to do rather than doing what we desire. In Kant's views, giving money to a homeless person out of sympathy does not have moral bearing. The same act would be a moral act only if the reason is based on the person's need and on the other person's duty to help. Kant's ethical theory is best described as categorical imperative. The core of this theory can be summarized in three principles, which are sometimes called formulas.

1. The basic principle: Act in the best way you can, as if that should become a universal law.
2. Principle of humanity: Act by applying humanity; treat yourself, as well as others, as an end, never merely as a means.
3. Principle of kingdom of ends: Every rational being must act as if they were a legislating member of the universal kingdom of ends (Kant, 1785; O'Mathuna et al., 2018).

There is no doubt that the categorical imperative is instrumental to the contemporary principle of human rights. Respecting human dignity and equal opportunity certainly are ways to treat people as an end, not as a means. This principle has largely influenced policy-making. As a matter of fact, more than 60 percent of the published opinions of the European Group on Ethics in Science and Technologies (EGE) between 2008 and 2015 adapted the deontological theory (Frischhut, 2019). Acting with goodwill brings goodness out of people based on the categorical imperative theory.

However, the challenge to the categorical imperative is the need to investigate what motivates people to perform their duty. O'Mathuna et al. (2018) argued that people would ignore their duty if there was no reason for them to perform said duty and no consequences that follow. The duty would simply be "lip service". On the contrary, rules might be followed "to a tee". However, the outcome might not be ideal because the understanding of the rule can be different. For example, the "golden rule" instructs us to treat others the way we want to be treated. The way we want to be treated may not be the same way others want to be treated. Happiness to you might be having flexible working hours, while to others happiness might be team members coming together at the same time to get things done. One's rule for happiness may bring unhappiness to another. Thus, there is a need to further develop this theory to "bridge the gap between what people fail to do and their recognition of what they are obligated (duty bound) to do" (O'Mathuna et al., 2018, p. 239).

Utilitarianism

Utilitarianism's moral conduct can perhaps be best described as "the principle that approves or disapproves of every action according to the tendency it appears to have to increase or lessen, i.e., to promote or oppose, the happiness of the person or group whose interest is in question" (Bentham, 1789, p. 7). Utilitarianism first defines whether an action is good or bad, with happiness, pleasure, and well-being seen as "good" and the opposite of these seen as "bad". Second, it judges if an action is correct or wrong based on these good-versus-bad criteria. Happiness and pleasure are good. Sadness and pain are bad. Finally, an action is evaluated exclusively on the consequence of an action: Correct, good ethics is achieved when the result or the outcome of an action is good for the majority. This theory was empirically developed by British philosopher Jeremy Bentham (1748—1832).

Utilitarianism
This is a form of normative ethical theory which seeks to bring the greatest happiness to the greatest number of people. This theory was empirically developed by British philosopher Jeremy Bentham (1748—1832).

Act utilitarianism

Since the core of utilitarianism is to maximize pleasure, Bentham explained the four sanctions, or sources of pleasure and pain, in his famous book on utilitarianism, *Introduction to the Principles of Morals and Legislation*, privately printed in 1780 and published in 1789. For Bentham, physical, political, moral, and religious sanctions bring either pleasure or pain. Pleasure or pain can be measured by intensity, duration, certainty or uncertainty, and nearness or remoteness. Because act utilitarianism quantifies (measures) pleasure, scholars named Bentham's ethical theory **hedonic calculus** (Dimmock & Fisher, 2017). This type of consequence-focused utilitarianism theory is also called act utilitarianism because this theory claims that the greatest happiness of the greatest number of people is the foundation of morals and legislation (Bentham, 1830, as cited in Browling, 1843).

Hedonic calculus
This is another name for act utilitarianism that is based on British philosopher Jeremy Bentham's theory that pleasure is measurable and quantifiable.

Rule utilitarianism

In contrast to act utilitarianism, **rule utilitarianism** "reject(s) the situation-by-situation calculations of act utilitarians [...], they hold that experience may be most reliably and usefully encapsulated into general rules, and that a better long-run result will be achieved by following rules than by situational calculations" (Hull, 1979). Like Bentham's hedonistic approach, English philosopher John Stuart Mill (1806—1876) relied on evidence to measure people's happiness. Yet, he took a qualitative rather than a quantitative approach. For Mill, "it is better to be a human being dissatisfied than a pig satisfied; better to be Socrates dissatisfied than a fool satisfied" (p. 7).

Rule utilitarianism
This type of utilitarianism rejects calculating pleasure. This theory formulated by John Stuart Mill focuses on the quality of the pleasure.

Utilitarianism might have mitigated the flaws of deontological theory by focusing on the consequence of the action. However, it is still subject to criticism. One criticism of utilitarianism is that it does not offer an obvious way of deciding between distributions of good consequences. Another criticism is that utilitarianism may have the wrong intention when seeking maximum pleasure. Peter Singer (1946—) attempts to deviate away from both hedonism and rule utilitarianism by emphasizing personal preferences. However, his theory falls victim to the same dilemma when "preferences of the majority seem to threaten a minority group or require us to sacrifice our integrity" (Dimmock & Fisher, 2017, p. 25).

The categorical imperative and utilitarianism are both popular normative ethical theories that dictate ideal moral practice. Both theories evolved centuries ago; now, they have become ethical foundations for most of the Western world. Their similarities and differences are summarized in the following table.

Table 4: Compare and Contrast Categorical Imperative and Utilitarianism

	Categorical imperative	Utilitarianism
Similarities	1. Part of the normative ethical theory 2. Evolved in the eighteenth century in industrialized European countries 3. Remain highly relevant and applicable to personal lives and businesses	
Differences	1. Focus on universal application 2. Act according to duty 3. Rules for performing duty well 4. Humane consideration 5. No measure/calculation of pleasure 6. Intention behind an action is important	1. Focus on consequence of the action 2. Focus on majority 3. Rules for producing maximum pleasure 4. Give majority privilege, overlook minority 5. Measured/calculated pleasure 6. Intention behind an action is not emphasized

Source: Created on behalf of IU (2021).

2.3 Business Ethics Concepts Evolving from Ethics Theories

We have already briefly explored the impacts of macroeconomy, mesosystem (organization), and micro-conduct (individual) on business ethics and corporate governance. Here, we further investigate how business ethics concepts evolve from ethical theories according to these three economic phenomena. Ulrich's (2008) rational and economic ethics will be adopted to explain ethics from a macroeconomic perspective. Ethics in a mesosystem will be explained through the concepts of business ethics developed by Rendtorff (2019) and Ulrich (2008).

Ethics from a Macroeconomic Perspective

In terms of the relationship between ethics and socio-economic well-being, Ulrich (2008) proposed three economic ethics models, namely, applied ethics, normative economy-backed ethics, and rational ethics. Applied ethics is instrumental to the theoretical development of business ethics under a mesosystem and a microsystem. Since it does not focus on the legitimacy of an economic activity or the consequence of said activity, Ulrich treats applied ethics as a managerial tool to guard the morality in an economy and serve as corrective economic ethics.

Integrative economic ethics

Ulrich (2008) defined **integrative economic ethics** as “an ethically rational orientation in politico-economic thinking without abandoning reflection in the face of the implicit normativity of ‘given’ economic conditions” (p. 3). This form of ethics does not provide applicable answers to ethical issues arising from economical activities. Rather, it intends to clarify the ethical blind spots within the pure reason of economics and economic life cycle. This concept is derived from Kant’s *Metaphysics of Morals*, where he wrote that skill and intelligence could have a market price, but human dignity does not have a price tag. Hence, an ethical economy should integrate both the measurable (the utilitarian doctrine) and unmeasurable human elements at the marketplace. The concept of integrative economic ethics is the foundation of rational ethics.

Integrative economic ethics
This is a rational oriented political economic consideration that integrates both utilitarian and Kantian ethical theories.

Rational ethics

Further attempting to establish a ground for the legitimacy of economic activity, Ulrich (2008) argued that this type of economic activity is built both on the foundation of normative moral and on a different socio-economic rationality. The difference would be “to assert the freedom of [a person] to determine [their] own life” (p. 4). Rational ethics is a way to reflect on the “general normative preconditions of the good life and just social relations” of free will and goodwill by people (p. 11). The deontology root of this theory is clear from his assertion that the Kantian’s idea of a morally responsible and mature person is the basis of rational ethics.

Ethics within a Mesosystem

Within a mesosystem, ethics is evaluated from the lens of organizations rather than from the perspective of global or national policy-makers. Business ethics is the term frequently used in this arena. Ulrich (2008) often discusses economic and business ethics as a joint term, while Rendtorff (2019) separates the two. Nevertheless, both hold a global vision when discussing business ethics. We will explore the concepts of ethics with respect to leadership, human capital management, market management, and innovation, in addition to general business ethics.

Business ethics

For Ulrich (2008), developing critical thinkers in **business ethics** through instruction is not enough. He found that the profit principle independent from ethical thinking still occupies the mind of many business managers. There is a gap between good justification of business existence and responsible ethics of managers. From Ulrich’s point of view, the legitimacy of a business should consider both profit-making and life-serving orientations. Business ethics uses the entrepreneurial actions of managers to mitigate the issues of social injustice and business legitimacy.

Business ethics
Based on maximum pleasure for a maximum number with the consideration of human dignity and human rights, business ethics develops well-justified values and norms that balance the profit-making and society-serving duties of an organization.

For Rendtorff (2019), “business ethics is the theoretical and practical work of developing well-justified values and norms for the function of business in society”” (p. 2). The key themes of his business ethics include conducting business with integrity, honesty, and fairness; the relationship with stakeholders and the issue of global responsibility; the responsibility towards human rights within a business and in the international community; and the international social legitimacy of business corporations. First and foremost, organizations should be virtuous. Virtues such as integrity, honesty, and fairness are perceived as good by employees and consumers because they promote loyalty. Utilitarianism is certainly another applied ethical theory adopted to guide business activities because maximizing profits could bring the business more pleasure.

Such pleasure is gained by serving the maximum number of customers as permitted by the capacity of the business. The limitation here is that happiness, along with many other benefits, cannot be quantified. Thus, utilitarianism reaches its limits, and we can look to Kant for a solution. Kantian business ethics focuses on other aspects of business duty, namely a stakeholder’s dignity and fundamental rights. By considering the rights of employees, consumers, suppliers, and stockholders to the greatest extent, businesses could expect to add non-quantifiable value (another form of pleasure) for all parties involved.

Equal opportunity

The owner of an enterprise cannot expect the business to survive without primary stakeholders, such as employees, customers, and suppliers. To maintain a healthy relationship, businesses take both deontological and utilitarianism approaches (Rendtorff, 2019). First, the deontological notion of human rights calls for equal opportunity. Businesses offer equal opportunities in employment and in engaging suppliers, regardless of race, color, age, and sex. National origin is not a concern unless there is a national security issue, such as the tension between the US and China. Additionally, businesses establish a written code of conducts or code of ethics to ensure that employees comply with the ethical expectations of the organization. Similarly, a set of financial and ethical evaluation criteria is used to monitor the continued fit of the suppliers. Lastly, the utilitarian’s orientation towards benefits and happiness for the majority comes into play whenever a choice has to be made, such as choosing whether to close an unprofitable production line to save the company or let it lag until it drags the entire enterprise down.

Consumer moral foundation theory

For a business, consumers are perhaps the most difficult group of people. When following a teleological belief, most businesses would strive for the highest level of customer satisfaction; yet, customers are emotional. Their moral foundation is based on “concerns about preserving purity and sacredness often characterized by a disgust reaction” (Willer, 2013, p. 57, as cited in Chowdhury, 2019, p. 587), and their opinion on whether to support or condemn a business action or product may not align with the business. Consumers can be ethical or unethical; in fact, “the rate of unlicensed software installation in 2015 across the globe was 39 percent with a commercial value of $52.2 billion; in the USA, this rate was 17 percent with a commercial value of $9.1 billion” (Chowdhury, 2019, p. 585). In addition to satisfying the majority of consumers, businesses have started developing products and services that provide accessibility to minority customers in the spirit of deontology belief, such as meatless products or wheelchair accessible entrances. However, businesses must also rely on legislation to address consumers’ unethical behaviors.

Responsible innovation

The aforementioned products and services are just a few examples of innovations responding to consumer needs. In the twenty-first century, responsible innovation has two main characteristics: 1) It is a type of responsive to societal needs, and 2) it is a strategic approach that becomes potential for business growth (Jarmai et al., 2020, as cited in Jarmai, 2020). In the context of innovation, being responsible means both taking the responsibility for business operations and for the impact the products and services have on the environment and society. Here, Kantian humanity applies because responsible innovation treats people and society as an end and not a means.

Ethics of Micro-Conduct

Whether it is on a global scale or on an organizational level, two groups of people are instrumental to ethical practices: leaders and non-leaders. So far, everything we observed and experienced are the decisions of individuals. Ethics under micro-conduct helps to shed light on how ethical theories have informed leadership and professional ethical conduct.

Moral-based leadership

The tune of ethics is usually set by the leadership of an organization, who guide, coach, and inspire employees to achieve the desired objectives. Moral-based leadership, such as authentic leadership, ethical leadership, and servant leadership, is one of the leadership styles that has seen a surge in popularity in the twenty-first century, largely because of the call for leaders to consider humane factors (Lemoine et al., 2019). One may find the influence of virtue ethics, consequentialism, and deontology quite obvious.

Leaders who adopt an authentic leadership approach would focus on self-awareness, i.e., on being a virtuous person first. By doing this, they honor the goodness in their lives. Their wisdom is used to pursue happiness for the greatest possible number of people. They are open to learning. They strive to be the best person they can be according to their own values. These leaders act on their virtues when they lead people and organizations. Their character aligns well with virtue ethics (Crisp, 2000).

Ethical leadership focuses on compliance to normative standards and is an adaption of deontological doctrine; it is the leader’s duty to comply to these standards (Lemoine et al., 2019). Leaders are expected to model their leadership in accordance with the moral values of stakeholders. Fairness, honesty, and integrity are some of the key characteristics of ethical leaders. This type of leader could introduce reinforcement or punishment to support the implementation of established rules and regulations because they believe that conducting business ethically will prevent many legal problems. Ethical practices earn the stakeholders’ trust. Along with putting other moral values into practice, ethical leaders demonstrate their respect for other human beings, fulfilling the humanity side of the deontological theory.

The goal of servant leadership is to empower others and to create value for the community, which shows its utilitarian roots. These leaders tend to give the employees the freedom to make decisions, rather than using their authority. They strive to balance the needs of all stakeholders: customer satisfaction, employee happiness, stockholder profits, government demand, and social responsibilities.

Professional ethics

On an individual level, many professions establish professional ethics. Finance, engineering, law, healthcare, real estate, and even media professions all have their corresponding ethical conduct. It is important for these professionals to streamline their practices with the public's expectations because their services and products will greatly impact the well-being, livelihood, and happiness of individuals. Along with many competence-related ethics, certain common behaviors are particularly desirable in these professions. For example, the key themes of accounting professional ethics are integrity and objectivity (International Ethics Standards Board for Accountants [IESBA], 2018). Professional engineers are expected to "uphold the highest standards of integrity, responsible behavior, and ethical conduct in professional activities" (Institute of Electrical and Electronics Engineers [IEEE], n.d., section 7). The IFJ (International Federations of Journalists) Global Charter of Ethics for Journalists urges journalists to respect the right of people to have access to information and ideas. They are expected to be fair and honest when presenting the information to the public (IFJ, 2019). In theWorld Medical Code of Medical Ethics (2018), the words duty, respect, and rights are used numerous times. For example, a physician has a duty to respect a patient's rights, as well as the rights and preferences of colleagues and other health professionals. They have the obligation to respect human life (World Medical Association, 2018). All in all, it is not difficult to see the deontological foundation in all these professions.

Table 5: Business Ethics Concepts Evolving from Ethics Theories

Economic environment	Business ethics concepts	Ethical theories	Applications
Macroeconomy (global focus)	• Economic ethics • Rational ethics	• Deontology • Rule utilitarianism	Global guidelines in economy and human rights aspects, cross-country policies
Mesosystem (organizational focus)	• Business ethics • Equal opportunities • Consumer moral foundation theory • Responsible innovation	• Deontology • Act utilitarianism • Virtue ethics	Organizational code of conducts, code of ethics, supplier engagement, talent management, consumer education, international operation management
Micro-conduct (individual focus)	• Moral-based leadership (authentic, ethical, and servant leadership) • Professional ethics	• Deontology • Virtue ethics	Individual conducts in organizations and individual practices

Source: Created on behalf of IU (2021).

After studying this unit, are you able to evaluate, from different perspectives, the case concerning a price increase that was introduced at the beginning of the unit? Do you arrive at the same answer when applying different ethical theories? What should we do? How can we make business decisions in such complex situations?

SUMMARY

Normative ethics has been around for centuries and continues to impact many aspects of our lives. Consequentialism, deontology, and virtue ethics exercise the greatest influence on business applications. Moral perfection-oriented virtue ethics forms the foundation for moral leadership. Human dignity and human rights considerations guide both government policy-makers and business leaders in establishing humane global strategies, with the goal to maximize the well-being of society. The level of moral development certainly evolves through time and experience, going through stages, such as working toward a personal reward to developing and contributing to universal moral principles. For professionals, the deontological and virtue ethics-based code of conduct or code of ethics could be their guide towards developing duty-oriented and human rights-based practices.

UNIT 3

BUSINESS ETHICS PROBLEM AREAS AND SOLUTIONS

STUDY GOALS

On completion of this unit, you will have learned …

- the categories of business ethics problems.
- the components of a corporate ethics program.
- how to implement an ethics program in business practice.

3. BUSINESS ETHICS PROBLEM AREAS AND SOLUTIONS

Case Study

Wirecard AG is a well-known German technology and electronic payment solution company founded in 1999 (MarketLine, 2018). Within twenty years, the company had grown into a multinational mega operation that had nearly five thousand employees and earned 1.490 million euro in revenue by the end of 2018. Their chief executive officer (CEO) was just 33 years old when he took the position and stayed for 16 years. Even more impressive, this young company took over the 150-year-old Commerzbank in Germany's 30-company DAX stock index (Syed et al., 2020).

However, senior management might have already been committing fraud as early as 2008. Wirecard was alleged to have attempted to bribe their auditor, Ernst and Young (McCrum & Palma, 2019). Ernst and Young, on the other hand, was also under scrutiny because of the suspicion that they had failed to reveal any types of irregularity in their audit reports. Additionally, the German supervisory agency BaFin was questioned for possible oversight. The outrage reached its peak when roughly two billion euro in cash could not be located or validated on Wirecard's account by their new auditor, KPMG. Presumably, the fund either never existed or was stolen. Since July 2020, Wirecard's former CEO has been detained (Matussek & Jennen, 2020), while the ex-chief financial officer (CFO) was released on bail (Thier, 2020). Wirecard filed for insolvency in August 2020 (Wirecard, 2020a).

While the investigation was ongoing, Wirecard's stock price plunged from over 145 euro per share to 0.69 euro per share (as of October 9, 2020) (Wirecard, 2020b). Investors and creditors filed lawsuits. People withdrew money from their Wirecard deposit accounts. Many pressing questions have been posed as to the problems behind Wirecard irregularities. Why do problems occur? Who should be held accountable? Are there ways to prevent this from happening again?

3.1 Categorization of Ethical Problems in Business

We have previously discussed business ethics concepts in three economic environments: macroeconomy (global focus), mesosystem (organization focus), and micro-conduct (individual conduct). We will carry a similar mindset to continue the discussion of business ethics problems by focusing on organizational and individual conduct in this unit. Not only do we categorize and recognize the issues, but we also look underneath these issues to explore the reasons behind their occurrence. Only then can we propose meaningful corporate ethics programs to address these issues.

Categorizing business ethics problems can be challenging because flaws can be found in almost every aspect of a business operation. Treviño and Nelson (2017) categorized the ethical problems from the point of view of individuals, managers, and organizations. They discussed topics such as people issues, conflict of interest, customer confidence, ethics issues involving multiple stakeholders, managing the "basics", and managing a diverse workplace. Ferrell et al. (2017) looked at this issue from a very different angle. They considered cybercrime, product safety, sustainability, financial misconduct, and the protection of intellectual property in the twenty-first century. Rendtorff's (2019) approach went beyond people, structure, and events. In his ethical problem framework, he included ethical traits such as integrity, honesty, fairness, dishonesty, manipulation, and fraud, as well as cultural and human rights. This unit will take an integrated approach to evaluating business ethics problems; we evaluate this topic from the perspective of business functionality, responsibility, relationships, and characteristics.

Duty versus Corporate Bottom Line

Whether it is business-to-business procurement or selling to individual consumers, and whether a service is provided to an organization or an individual, a business is accountable for fulfilling many duties associated with these business transactions. These may include legitimate sourcing, product safety, the quality of the product and service described, the ordered quantity, the timely delivery to meet customer needs, and the timely payment of vendors. These are some of the fundamental duties that are instrumental to the existence and survival of the business.

Unfortunately, companies often fail to perform one duty or another as a result of financial unworthiness. Ford discovered a malfunction in a component of the gas tank on its Pinto model car in the 1970s (Jennings, 2012). The problem could cause fuel leakage and fire. The replacement of the part would cost just $11. However, the estimated total cost to replace all 11 million cars and 1.5 million light trucks would be $137 million. This cost was evaluated against the cost to pay for those reported deaths, injuries, and damages for a total of $49.15 million. Since the decision not to replace the malfunctioning part would be more beneficial to the company, that was the decision they made. Ford chose not to perform its duty to address a quality problem in exchange for saving money (Jennings, 2012). The financial bottom line is, undeniably, one of the most important objectives for an enterprise. Unfortunately, it is often the only thing leaders care about.

Human Rights versus Emerging Market

"Who is responsible for human rights violations?" (Kriebitz & Max, 2020, p. 246) is the question multinational enterprises (MNEs) often ask themselves when dealing with cross-national businesses, particularly those in the emerging markets. Some argue that the offender is responsible; others say that it is a political issue and that governments should be responsible. The United Nations Guiding Principles on Business and Human Rights (2011) makes it clear that both governments and corporations are responsible for respecting human rights. Corporations should "avoid causing or contributing to adverse human rights impacts through their own activities" and "seek to prevent or mitigate adverse human rights impacts that are directly linked to their operations, products, or services by their business relationships, even if they have not contributed to those impacts" (UN Global Compact, 2011, p. 13).

With that said, MNEs must learn how to prevent or mitigate those adverse impacts when conducting business with or in emerging markets where the local ethical development may differ. For example, most large, private Chinese businesses were only established in the last thirty years. Newer which are still in the survival stage are not as familiar or concerned with international human rights. As they mature into a more sustainable stage of corporate development, awareness of such issues can be integrated into business practice (Ma et al., 2020). Giuliani et al.'s (2020) argument is that an organizational ethical misalignment could occur at different stages of development: growth stage, sustainable stage, or attainment stage. When an ethically "mature" MNE operates in a developing country, should they "lower" their ethical standard and "do what Romans do" or stand up to local human right violations and risk losing business?

Ethical Culture: Minority versus Majority

Let's direct our attention back to the Wirecard case. Two key words describe their ethical problems: fraud and bribery. Reading between the lines, you may discover other ethical issues: breaking trust, negligence, dishonesty, or financial manipulation. They may seem like individual misconduct on the surface. However, one person can neither commit a crime at such a scale nor cover it up for such a long time in a large organization. There was an organizational oversight throughout. It is an indication that the internal control breakdown, possible conspiracy, and corporate governance failure are at an organizational level. Unsurprisingly, the scandal was named the "Enron of Germany" (Browne, 2020).

Minority
In the context of corporate ownership, this refers to people with fewer share rights.

Indeed, both Enron and Wirecard scandals have many things in common. The common theme is how the **minority** (the scammers, the corporate leadership, and the supervisory board) ruined the lives and trust of the majority (the investors, the shareholders, the customers, and their employees, etc.). The question now is beyond what they did or how they did it; the question is, why?

On the Wirecard website, you can find a wealth of information about their products and markets (Wirecard, n.d.). What you cannot find, however, is what they believe in: their values, what they are willing to be responsible for, or their code of conduct. The only information with regard to corporate governance is an annual two-page "Declaration of Compliance" and a three-page "Fundamentals of the WIRECARD Compliance Management System".

Although Wirecard has replaced Commerzbank in the *Deutscher Aktien Index* (DAX) 30, the 150-year-old Commerzbank apparently has a better governance program. Their comprehensive governance program includes a 42-page code of conduct that details their values, their responsibility to stakeholders, and how they deal with conflict of interests, among other things. This is followed by a compliance program and a whistle-blowing program. Their "regulatory self-classification" lists both domestic and international regulations that the bank is subject and adheres to (Commerzbank, n.d.). In contrast to Wirecard, Commerzbank has demonstrated a degree of transparency and willingness to take responsibility for the public good.

Fraud versus Ambition

In 2013, one of the executives at the head of the structured credit trading at Credit Suisse Group was sentenced to 30 months of imprisonment for falsifying financial records (McGrath, 2020). The executive, Kareem Serageldin, a Yale University graduate, managed a billion-dollar portfolio and earned an annual salary of $7 million by the age of 33. During market distress between 2007 and 2008, Mr. Serageldin allegedly pressured his subordinates into changing numbers and ignored the wrong trading marking that contributed to making a loss look like a gain. During his judicial hearing, he indicated that money was not his concern. One of the reasons why he committed the crime was he wanted to protect his "reputation". The reputation he had earned over the years was that of "the investment banking monk" who could solve all kinds of problems (McGrath, 2020, p. 527). He did not want to let the top management down.

Markus Braun was also 33 years old when he was named CEO of Wirecard and another case of youth and ambition. According to a KPMG "Global Profiles of the Fraudster", a typical fraudster is between 36 and 45 years old, and an executive in finance, operations, or marketing (Rossouw & Van Vuuren, 2017). They have usually been employed for over six years. Mr. Braun and Mr. Serageldin seem to fit this profile well. Youth, ambition, and success are not a crime. Who is to ensure that these young and ambitious executives are morally successful?

The graph below summarizes the four ethical problems discussed in this section. The circle represents some of the core business activities and operating focuses. The rectangles illustrate some of the ethics problems associated with the selected business topic. While other ethics problems do exist, they may not be as substantial and critical as the ones discussed in this unit.

Figure 2: Summary of Ethical Problems

Source: Created on behalf of IU (2021).

3.2 Components of a Corporate Ethics Program

The pressure of overwhelming ethics problems prompts organizations to seek effective measures to proactively combat the potential harm that those problems could cause. These comprehensive, integrated measures form a corporate ethics program (CEP). In the US, the CEP framework typically includes the following:

- a series of policies and procedures,
- the appointment of an ethics officer,
- internal systems to monitor, audit, and report any misconduct, and
- the communication and training of ethics (Ferrell et al., 2017).

Code of ethics (COE)
This code provides high-level ethical practice guidelines within an organization.

Within the policies and procedures, two common documents are the code of conduct (COC) and **code of ethics** (COE). Corporations usually establish either a COC or a COE because these two documents serve the same purpose, albeit with slight differences. The COE tends to be a broad, high-level guideline that outlines the company's value principles, ethics, and practices concerning its relationship with all stakeholders and society (Singh et al., 2018). In the spirit of the COE, a COC details the expected actions under ethically challenging circumstances. COE and COC can be designed for both internal and external users. A KPMG 2015 survey found that 76 percent of the Fortune Global 200 firms had a COE and that 42 percent of Asian firms had a COE.

Japanese firms may treat ethics as a part of compliance activities. Honda establishes both COC and corporate governance, the latter of which includes ethical elements. The Nippon Telegraph and Telephone Corporation ([NTT], n.d.-a; n.d.-b) separates CSR and governance programs. The ethics charter falls under the governance program as well. Similarly, Chinese companies Tencent and Lenovo also rely on CSR and governance programs. However, ethics is not mentioned in either program.

In Germany, instead of developing ethical programs of their own, companies focus on corporate governance by complying with the German Corporate Governance Code (GCG Code) published by the Government Commission on the German Corporate Governance Code. Companies usually publish an annual, one-page declaration of compliance with the German Corporate Governance Code. Some of them publish a more detailed declaration on corporate governance called the Corporate Governance Report.

A COE typically contains the company's purpose; the firm's values and beliefs; their responsibilities; the topics covering legal mandates; the facilitation of ethical culture; corporate citizenship or CSR; and implementation and enforcement. Ferrell et al. (2017) specify that "75 US firms reported that their codes of ethics were similar in content and the content was often vague" (p. 224).

Corporate Ethics Program Example: Walmart

Walmart is a US-based global retailer employing 2.2 million employees worldwide as of September 21, 2020 (Fortune, n.d.-a). With a revenue of $523 billion, it ranks first on the 2019 Fortune Global 500. It is also one of the top 200 most admired companies. Walmart's CEP includes all the four components we illustrated at the beginning of this unit.

Ethics and compliance leadership

Walmart appoints a group of corporate ethics and compliance officers (CECO) which reports to the audit committee and the board of directors. The nine-member leadership team leads 2,000 corporate ethics and compliance staff that are responsible for the ethics and compliance in their perspective market worldwide (Walmart, n.d.-a). Their corporate ethics, compliance, and risk committee comprises CEOs and CECOs from each international market. Together, they formulate and monitor the ethics and compliance programs.

Ethics and compliance policies

Walmart's policies and guidelines cover a wide range of topics, from animal and environmental protection, genetically modified organisms (GMOs), and human rights to pricing, privacy, and social media (Walmartethics, n.d.). Their statement of ethics and standard for suppliers provide guidelines for both internal and external stakeholders. Their compliance policies lay out their anti-corruption, anti-trust, anti-money laundering position, as well as their views on labor and employment, health and wellness, and product safety.

Walmart's statement of ethics highlights the firm's beliefs and how they lead with integrity in the workplace, marketplace, and communities. It provides their ethics web page, helpline, and various reporting methods (Walmartethics, n.d.). The standards for suppliers require suppliers to be transparent, not use involuntary or underage labor, and respect the individual in all phases of employment (Walmart, n.d.-b).

Ethics communication, training, and audit

Communication is the key to spreading the message and to make ethics and compliance known to the employees. Walmart's ethics website provides their content in 20 languages (Walmart, n.d.-c). Their anti-corruption materials are offered in 10 languages. The company completed 200,000 computer-based training programs and 10,000 instructor-led training programs in the 2019 fiscal year. In addition to enforcing a system of screening, tracking, and monitoring contractors, Walmart hires third party ethical agencies to conduct audits of those contractors. In 2019, 230 audits were completed.

Corporate Ethics Program Example: Honda and NTT Group

Honda is a Japan-based auto manufacturer with 218 thousand employees worldwide (Fortune, n.d.-b). With $137 billion revenue, it ranks number 39 in the 2019 Fortune Global 500 and is among the 200 most admired companies. Honda's CEP includes four components similar to those we have pointed out.

Honda's ethics programs fall under the compliance section of corporate governance (Global Honda, n.d.; 2019). To comply, Honda has taken the following measures to address ethics:

1. They appointed a compliance officer to lead the compliance committee. The committee makes critical decisions on compliance policies and internal control systems.
2. They published a code of conduct. This includes initiatives to prevent bribery and initiatives for the prevention of anti-competition.
3. They established a business ethics improvement proposal line. This open communication line accepts suggestions and reports of ethical concerns from all employees, subsidiaries, and suppliers in the form of emails, letters, faxes, or phone calls. In 2019, this line handled and investigated 445 suggestions and concerns.

3.3 Ethics Implementation in Business Practice

In addition to establishing a comprehensive corporate ethics program, individuals and organizations may have to decide how to act when an ethical dilemma arises, as in the case presented at the beginning of this unit. Chances are that decisions would be different depending on the chosen ethical framework. Hence, ethics implementation can take a different form at different levels and stages.

Recruitment

Organizations could be more proactive and ethically cautious when selecting and hiring a new employee. During the selection stage, diversity, lack of discrimination, fairness, and integrity should be exercised and demonstrated by human resources and hiring managers (Villegas et al., 2019). The ethical orientations of candidates should be assessed and evaluated. A **guilt and shame proneness (GASP) scale** is being developed to identify the level of candidate's guilt and shame when given a hypothetical ethical dilemma. A person who reports a higher levels of guilt and shame during the survey would be a person who values ethics highly. Once the most qualified person is onboard, the company can make ethics training a priority. Ethical expectations should be communicated immediately. Ethics training is subsequently provided to ensure the new employee is fully aware of the firm's ethics practices.

Guilt and shame proneness scale
This could be an innovative tool to assess ethical orientation during recruitment.

Personal Awareness

Consequentialists focus on the outcomes, namely, the possible repercussions for oneself, clients, the organization, and colleagues. A decision would be made by "calculating" the benefits and harm to all stakeholders. Most likely, the decision would be beneficial to the greatest number of people. Through a deontological lens, one evaluates the situation according to their ethical duties, obligations, and principles. Personal ethical roots are one of the places from which people draw their ethical principles. Another place is the great influence from society, such as the Christian belief in Western countries, Islamic teaching in most of the Middle East, or Confucianism in Asia. Each could take to an entirely different approach.

Immanuel Kant's "categorical imperative" offers another decision-making alternative: Should others follow my action? If the answer is yes, then it is a good decision. A good decision could apply to others and it could become a universal law. Furthermore, one's ethical decision could be from their desire to be a virtuous person. Here, the focus is on personal characteristics rather than the actions one takes. Lastly, a "Hippocratic oath of managers" could be adapted by corporate leaders based on the following principles (Trevino & Nelson, 2017, p. 50):

- service to the public and society
- balance of multiple stakeholders' interests
- acting with integrity in the enterprise's interest

- adherence to the law
- respectful and unbiased decision-making
- professional development
- accurate and transparent reporting
- responsibility to protect the profession

Whistleblowing

Whistleblowing
This is an effective tool to disclose corporate misconduct.

Another aspect of implementing ethical practice is to encourage both internal and external people to raise concerns about unethical conduct. When every other effort fails, **whistleblowing** is an effective method to stop and change conduct that may have been overlooked. For example, Wirecard's misconduct was brought to the public's attention by journalists. Enron's misconduct was reported to the US government by an internal employee. External auditor PriceWaterhouseCoopers (PWC) raised concerns that "Amazon, Apple, IKEA, and Pepsi are channeling billions of dollars via Luxembourg because of its favorable tax practices, thus avoiding paying taxes in other EU countries" (Kenny & Bushnell, 2020, p. 644). Without these brave individuals, stakeholders may be swindled or fooled, the damages of those violations may be more severe, and criminals might not be punished.

In the US, two laws encourage and reward whistleblowers. The False Claims Act encourages reporting on the frauds of government contractors. If found guilty, the fine would be from three to five times the fraud amount; 15 to 30 percent of the fine is awarded to the whistleblower. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2008 governs the financial industry. Whistleblowers must provide original information, and the US Securities and Exchange Commission (SEC) will award them between 10 and 30 percent of a recovery greater than $10 million (Treviño & Nelson, 2017). However, the disadvantage of financial reward is that it could become the main motivation when it comes to reporting wrongdoings (Latan et al., 2019). Ultimately, the whistleblower could wait until the violation amount is more substantial to receive a larger amount of the reward.

To ensure self-protection and effective reporting, whistleblowers may gain a trusting audience by understanding internal or external compliance environment. The individual is encouraged to go through the internal reporting channels first. When that fails, they should report to a government agency or bring the matter to the media's attention. Whistleblowers certainly should consider the possible consequences for themselves, the offenders, and for the organization. Whistleblowers may have to act as content and legal experts to present the facts in a way that the audience can understand (Treviño & Nelson, 2017; Kenny & Bushnell, 2020).

Cyberspace Ethics

In a 2020 US Senate Commerce Committee hearing, both Democrats and Republicans criticized Facebook, Twitter, and Google for content modification on their platforms. Facebook CEO Mark Zuckerberg's rebuttal was: "The fact that both sides criticize us doesn't mean that we're getting this right, but it does mean there are real disagreements about where the limits of online speech should be" (Romm et al., 2020, para. 4). Indeed, who should be responsible for the ethics behind cyberspace activities?

Miedema (2018) argued that freedom of expression is a people's right; yet, she acknowledged that "one's right to exercise the freedom of expression by using the internet implies a corresponding duty to avoid interfering with other people's rights to do the same" (p. 69). Thus, social media companies should not get involved and censor the contents on their platform unless the content is harmful or illegal. However, internet technology companies have the duty to protect consumers and users. Consumers and users have the right to be forgotten and to be left alone. For this reason, internet companies are accountable for protecting the personal information that users share with them unless the users consented to the sharing of their information. The EU, Australia, the US, and New Zealand have all published legislation in this regard. Still, the framework of cyberspace ethics is not flawless. The framework is yet to be completed and refined.

SUMMARY

Ethics problems continue to have negative effects on society. The problems could be incompetent leadership, organizational greed, or society misjudgment. These problems negatively affect consumer confidence and community trust. We must address these problems sooner than later before they destroy business environment we rely on. A comprehensive ethical framework is one approach that corporations adopt. This framework includes appointing executives to lead the corporate ethics program, establishing corresponding policies and procedures, communications and training, and regularly reviewing the implementation of the program. Other methods of implementing ethical practices are recruiting the right people, providing whistleblowing channels for voicing concerns, and being ethical in both direct contact and virtual environment. For an ethical program to work, individuals should be aware of their personal ethical orientation. Leaders may apply a "Hippocratic oath of managers" to their practice.

UNIT 4

BASIC PERSPECTIVES OF CORPORATE GOVERNANCE

STUDY GOALS

On completion of this unit, you will have learned …

- why corporate governance is important.
- how, historically, trust problems between agents and principals developed into solutions for corporate governance.
- about corporate social responsibility and sustainability.
- the approaches to corporate governance.
- how surveillance can be differentiated.

4. BASIC PERSPECTIVES OF CORPORATE GOVERNANCE

Case Study

On November 3, 2020, many news outlets reported that the largest initial public offering (IPO) in history, Ant Group IPO, had been suspended by the Chinese government less than two days before the scheduled trading date (McMorrow & Lockett, 2020). The government claimed that the business model at Ant Group would encourage young people to overspend and create a potential socioeconomic problem. Some regulation was since brought into force to limit the borrowing with financial constraints. The suspension would eventually cost the company millions of dollars, and some investors suffered financially. The revelation surely cast doubt as to how much a government should be in control of corporate governance.

4.1 Important Terms and Definitions of Corporate Governance

We know that corporate governance is a control and directing framework used by the board of directors to balance the economic and social goals of an organization. Like ethics, corporate governance can be approached from global, national, and organizational levels. In this unit, we will discuss in depth the effect of corporate governance on these three levels. Furthermore, we will take a closer look at the relationship between sustainability, corporate governance, and corporate social responsibility.

The very first question we may ask ourselves is why the pursuit of corporate governance in a society values “freedom” and “rights”? After all, the strong “control” element within governance is in contradiction with free choice and free will. Morck and Steier (2005) shed light on this matter. The first reason for this is the lack of trust in corporate leaders. Whether owned by families or managed by corporate CEOs, corporations have had the ability to do good deeds for customers and employees by exercising through free will for the longest time. However, the repeated occurrence of power abuse prompted society to reconsider whom they should trust. The second reason concerns the imperfections inherent in capitalistic systems. Shareholders rely on capitalism to preserve and grow their wealth. Yet, they cannot control and monitor the capital they invest in when they are, individually, a minority. They must rely on a third party. Their financial institutions and state government are thus held responsible to ensure that corporations behave according to the expectations of law and society. Thirdly, as businesses grow from small family-owned shops to large organizations, the governance of these business groups becomes critical. Governance system and structures have proved to be an effective way of organizing and managing these groups.

The second question is why international organizations are involved in corporate governance if this seems to be under the state's jurisdiction. The answer may come from two aspects: sustainability and corporate social responsibility.

Sustainability

This topic has drawn international attention since 1987, after the UN Commission for the Environment published *Our Common Future: Sustainable Development in International Politics*. The report was much needed in the wake of exploitation of natural resources, the greenhouse effect, and global warming. **Sustainability** is the responsibility of humanity "to leave the earth and its resources in good condition for future generations" (Rendtorff, 2019, p. 116). Also called the Brundtland Report, this report highlights five sustainability principles:

Sustainability
This is a humane act aiming to save the earth and preserve natural resources.

1. Focus on nature and development
2. Link between nature conservation and community development
3. This concept is neither purely utilitarian nor completely instrumental
4. Can be integrated with ethical principles
5. Value expression for stakeholders

These principles later formed the foundation for Organization for Economic Cooperation and Development (OECD) principles of corporate governance.

Corporate social responsibility (CSR)

The answer to who will be held responsible for sustainability is, naturally, corporations because they were the driving force behind the creation of those environmental issues. **CSR** can be described "as a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis" (Commission of the European Communities, 2001, p. 7). Under this concept, corporations have four responsibilities (Rendtorff, 2019; Treviño & Nelson, 2017).

CSR
This is a corporate initiative that incorporates social and environmental concerns with business activities.

1. Economic responsibility. This is the primary reason for a corporation's existence. Corporations are accountable for providing the monetary funds to pay their employees and suppliers, to make a profit, and to pay taxes to the government for funding public affairs.
2. Legal responsibility. This means that corporations must ensure that the money is earned through legitimate business and lawful activities.
3. Ethical responsibility. This implies respecting the ethical values and code of conduct within society and the organization.
4. Philanthropic responsibility. These are the expectations that society has of the company. It is expected that corporations contribute above and beyond regulated obligations.

However, critics of CSR call it "window-dressing" (Rendtorff, 2019). Critics argue that CSR dissolves the capitalist economic system and that it is undemocratic. They claim that CSR leads to socialism, where shareholder profit becomes a secondary concern, and that CSR forces the company to shift from an economic entity to a political organization. The struggle has been ongoing and will likely continue as a growing number of companies moves toward taking on social responsibilities.

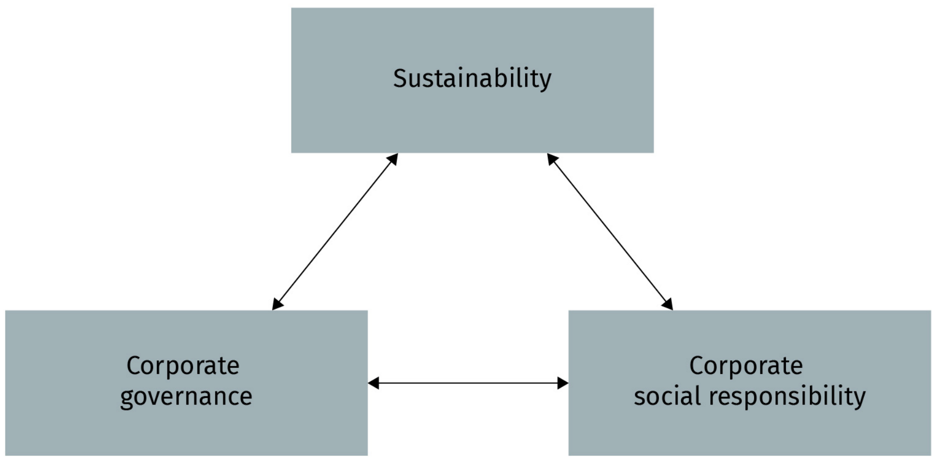
CSR-Based Corporate Governance

Acknowledging CSR indicates that a company takes people, the planet, and profit to heart. CSR-based corporations would likely consider these elements in governance programs and economic strategies. It would address shareholder rights, carefully select executives, be transparent about the directors' wages and financial reporting, adhere to regulations and ethical rules, and include stakeholders in their decision-making process. These practices may sound too idealistic, yet they are efficient evaluation criteria that help to keep companies on track (Mostepaniuk, 2017).

Socially responsible companies tend to be sustainability-conscious. When sustainability is the key driving force for organizations to produce innovative products and business models, the products and services are created to guarantee the well-being of future generations and to safeguard irreplaceable natural resources. This assertion was made based on a study of Thailand's award-winning companies in CSR, corporate governance, and sustainability between 2010 and 2015 (Virakul & Russ-Eft, 2019). The relationship between these three factors is illustrated below.

When embedded at the strategic level and at the business activities level, CSR, corporate governance, and sustainability increase the firm's competitive advantage, improve financial performance, and enhance employee and stakeholder satisfaction. Adel et al. (2019) drew the same conclusion in their research of 350 companies operating in 16 European countries.

Figure 3: The Relationship between Sustainability, CSR, and Corporate Governance



Source: Created on behalf of IU (2021).

Here, we use the example of the British Petroleum (BP) Gulf of Mexico oil spill case to illustrate the relationship between sustainability, CSR, and corporate governance. On April 20, 2020, BP's offshore drilling rig exploded and sank in the US part of the Gulf of Mexico. The accident caused the death of 11 workers; four million barrels of oil flowed into the Gulf for over 87 days before the well was capped. The US and BP eventually settled on a $5.5 billion Clean Water Act penalty and a fine of up to $8.8 billion in natural resource damages (United States Enviromental Protection Agency [EPA], n.d.-a). The massive damages to marine life, natural resources, and human health have been very difficult to assess and quantify. In addition to oversight on the operations side, the investigation also discovered flaws in the regulation of offshore drilling, as well as a lack of coordination among US government agencies (National Commission on the BP Deepwater Horizon Oil Spill and Offshore Drilling, 2011). The incident and discovery led to several policy changes in the energy sector including

- requiring energy-efficient automobiles and other vehicles,
- managing the inherent risks of the domestic production of oil and gas (including offshore areas),
- requiring safe operations to protect human health, and
- protecting the natural environment.

Had the US government agencies enforced corporate governance and BP taken proactive actions to consider their social responsibility, natural resources would have been preserved (sustained) and financial losses could have been prevented.

Corporate Governance Theory

Now that we have answered the question of why corporate governance is necessary, we will delve deeper into the topic to understand the theoretical foundation of corporate governance. Several philosophical theories are instrumental: agency theory, stewardship theory, and systems theory (Tricker, 2019).

Agency theory simply refers to the relationship between the shareholders and the members of the board of directors as a principal-versus-agent relationship. Agents agree to perform services on behalf of the principal. They monitor companies where the principal has financial interest and make decisions for them regularly. This theory assumes that both the principal and the agent are seeking to maximize their own benefit. Agents might not always make decisions with the best interest of the principal in mind. In fact, agency theory holds that there are inherently conflicting interests between shareholders and managers, which could only be mitigated by strong control measures. For example, when Wirecard's management started to engage in fraudulent practices without the shareholders' knowledge, the managers acted in their own interest, not in the best interest of the company and its owners/shareholders.

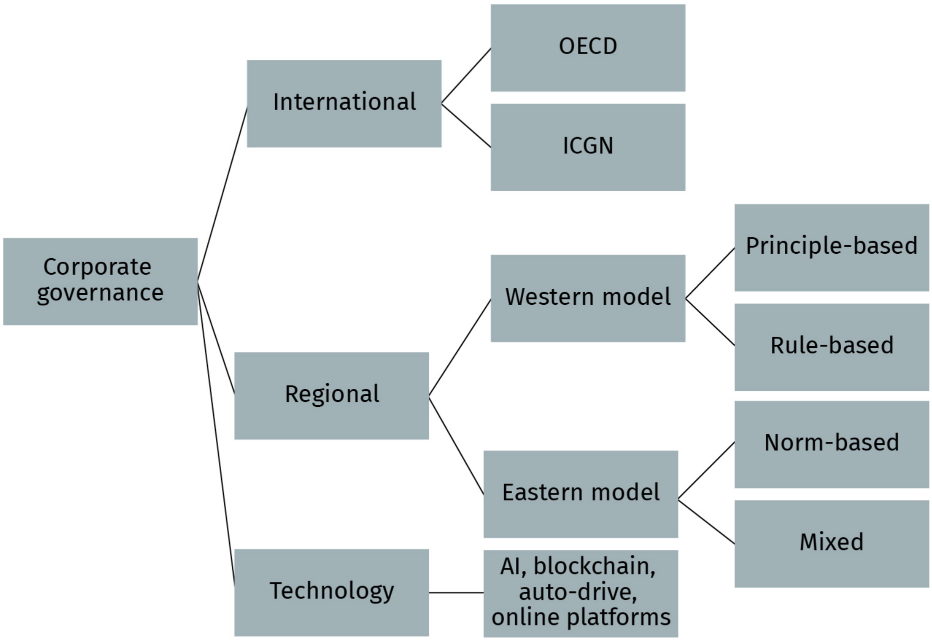
In contrast to agency theory, stewardship theory argues that the directors' duty is only towards the shareholders' interest because they are appointed by the shareholders and therefore legally bound to protect their interest. This theory acknowledges that governance failure could occur even when most directors have fulfilled their duty faithfully. It assumes that managers seek self-actualization. Therefore, stewardship theory denies generally conflicting interests between shareholders and managers. When such conflicting interests occur, they are seen as positive because different perspectives are regarded as conducive to creative problem-solving. For this reason, shareholders should not exercise strong control over managers, but rather provide an enabling environment in which managers can strive for self-actualization. This theory takes legal compliance and organization study as its framework. However, time and time again, the fall of major companies has called for the empowerment of shareholders.

Systems theory views the economic, social, legal, and political factors, along with organizational factors, as a hierarchy of systems. They are independent within their own system yet intertwine with each other. Operating in complex environments, systems theory seeks to set boundaries, levels of abstraction, and functions for corporate governance to address specific issues arising from interactions among senior management, shareholders, boards of directors, and other corporate stakeholders. Systems theory is by far the most appealing approach to corporate governance due to its integrative nature.

4.2 Approaches to Corporate Governance

Our previous discussions have revealed that corporate governance is a global initiative associated with heavy regional differentiation. Within a region, culture and political background is another determinant that drives the country's choice to approach corporate governance. These approaches can be collectively divided into the Western model, represented by the UK/Commonwealth, USA, and continental Europe, and the Eastern model, represented by Chinese, Japanese, South Korean, and other Asian models (Tricker, 2019). We have previously made structural comparisons between Anglo-American, German, and Japanese models. The difference in the structural approach is mainly one-tier or two-tier boards. In this unit, we will dive further into regional or country approaches by looking at the substance of this phenomenon. The substance difference may be principle-based, rule-based, mixed, or norm-based. This framework is illustrated in the figure below.

Figure 4: Corporate Governance Framework



Source: Created on behalf of IU (2021), based on Kaplan Financial Knowledge Bank (n.d.).

International Approach: OECD and ICGN

Founded by the members of industrialized countries in 1961, the Organization for Economic Cooperation and Development (OECD) strives to establish cooperative policies around the world. As such, the objectives of the G20/OECD Principles of Corporate Governance (OECD, 2015a) are to assist member and non-member countries to develop and improve their legal, institutional, and regulatory framework (Kaplan Financial Knowledge Bank, n.d.). The International Corporate Governance Network (ICGN) is an international investor-led organization that strives to promote high standards of professional practice and investor stewardship. Its members are global investors managing more than $54 trillion in assets. The ICGN publishes the Global Governance Principles and Global Stewardship Principles (ICGN, n.d.). The differences among the three principles are illustrated in the table below.

Table 6: Differences among Three Principles

Name	G20/OECD Principles of Corporate Governance	ICGN Global Governance Principles	ICGN Global Stewardship Principles

Objectives	Establish a common basis that OECD member countries consider essential for the development of good governance practices	Consider corporate governance elements that ICGN-investing members when making asset allocations and investment decisions	Sets up a framework to implement stewardship practices in fulfilling an investor's fiduciary obligations to beneficiaries or clients
Principal highlights	Establish the basis for an effective corporate governance framework; the rights and equitable treatment of shareholders, institutional investors, stock markets, and other intermediaries; the role of stakeholders; disclosure and transparency; the responsibilities of the board	Board roles and responsibilities; leadership and independence; composition and appointment; corporate culture; risk oversight; remuneration; reporting and audit; shareholder rights	Internal governance; develop and implement stewardship policies, monitor and assess invested companies; engage collaboration; exercise and protect voting rights; promote long-term value creation and integration of environmental, social, and governance factors; meaningful transparency, disclosure, and reporting
Who uses it	Member jurisdictions and non-member countries	Member institutions	Member institutions

Source: Created on behalf of IU (2021).

The Western Model: "Principle-Based" ("Comply or Explain")

This principle-based model, also referred to as "comply or explain", requires companies to report their compliance to the governance principles outlined by their national code of corporate governance or explain why they deviated from the code (Tricker, 2019). This approach allows a differential application and even ignoring a part of the guideline when the situation warrants it. Firms taking this approach focus on board responsibilities. Historically, the UK and Commonwealth countries have been the driving force behind this approach. Now, this practice has extended to many OECD member countries and beyond. According to the OECD (2019), roughly 40 countries have adapted this approach. Furthermore, most non-OECD member jurisdictions also favor principle-based governance to show trust in their organizations. However, failing to identify consequences for non-compliance leaves room for bias and prolonged actions.

The Western Model: "Rule-Based"

The rule-based corporate governance approach is predominately adopted by the United States. Compared to the guiding orientation of the OECD code, rule-based legislation is more detailed and contains built-in punitive terms. Although the broad understanding is that common law has been the foundation of the American legal system, the concept of protecting the legal rights of shareholders in America was not inherit in English law (Hilt, 2014). Rather, it evolved from many cases of corporate crisis. The US state and federal legislation developed those laws in the wake of combating new financial manipulations during the twentieth century. The federal governance agency of the US Securities and

Exchange Commission (SEC) has been the federal authority responsible for establishing and enforcing the laws for investor protection, auditing requirements, and financial disclosure of public companies. Rule-based governance mandates compliance, leading to increased investor confidence in the stock market. However, the rules may not be applicable to all businesses. The rigid requirements may encourage companies to take advantage of loopholes when some aspects cannot be easily regulated.

Some pieces of legislation do consider both aggravating and mitigating factors (Treviño & Nelson, 2017). Rules can be used as a punitive tool, as well as a tool to promote positive corporate governance. An example of US Sentencing Guidelines dictates the following for culpability scores:

- Committing similar violations in the past five years adds two points.
- Obstructing an investigation adds three points.
- Cooperating and accepting responsibility for the criminal conduct deducts five points.
- Establishing an effective governance program deducts three points.

The Eastern Model: Chinese Mixed Approach

The Chinese model blends both Western and Eastern elements, as can be observed in official policies, legislation, and informal norms (Park et al., 2020). On the one hand, agency theory plays an important role in establishing the contractual relationship between the board and shareholders. This is quite new to China as it is shifting from a planned to a market-based economy, which means that structural holes are possible. Directors are expected to utilize their education and experience to fill these structural holes. On the other hand, relationship building is a critical and unique factor. Directors are held responsible for developing inter-organizational ties and establishing or enhancing the ties between the organization and the external constituents. These efforts would support the implementation of corporate governance as they fit the cultural norms. As such, directors can sit on multiple boards simultaneously.

Chinese state-owned entities have unique structures. In addition to the traditional board-executive-employee structure, state-owned entities often have another executive body with staff appointed by the state to work in parallel with the other set of operating executives. The main functions of the state-apppointed executives are to keep close ties with the state, enforce state policies, and control resource allocations. Sometimes, retired state officials are hired as board members or executives to balance the relationship between the central and the local governments (Park et al., 2020).

The Eastern Model: Japanese Keiretsu Model

The Japanese **keiretsu** model has been instrumental to Japanese economic development. The term *keiretsu* refers to Japanese intercorporate networks. *Keiretsu* are "clusters of independently managed firms maintaining close and stable economic ties, cemented by a governance mechanism such as presidents' clubs, partial cross-ownership, and interlocking directorates" (Grabowiecki, 2006, p. 1). From an ownership perspective, four types of *keiretsu* dominate the Japanese corporate groups: capital groups, corporate groups, system of suppliers, and mixed members. From a functional perspective, horizontal *keir-*

Keiretsu
This is a Japanese corporate governance model that links social and economic ties with business practices.

etsu operates around its main bank in a city, while vertical *keiretsu* operates within its industry. *Keiretsu* serves the functions of risk management, information sharing, and strategic coordination.

As previously discussed, banks play an important role in corporate governance in Japan. Horizontal *keiretsu* conveniently enables the interaction between financial institutions and corporations. Vertical *keiretsu* enables another Japanese governance feature: cross-shareholding. Cross-shareholding strengthens the ties between corporate groups hoping to stabilize the industry and, by extension, the economy. Another element of Japanese corporate governance is labor relations. Loyalty is highly encouraged and expected. *Keiretsu* makes it possible for managers to progress through tenure and even reach board level (Tricker, 2019; Grabowiecki, 2006).

Due to the close ties between financial institutions and corporations, Japan has relied on informal relationships for corporate governance, i.e., banks bail out companies and are not allowed to fail (Kobayashi, 2020). The *keiretsu* structure stabilizes this relationship by allowing banks to own a fair share of corporations. This practice expects the government to rescue the distressed banking organizations during a financial crisis. However, the government's intervention can be unpleasant when everything seems to be failing. The government could force mergers to solve the problem. *Keiretsu* could cause negative ripple effects due to its interlink and interconnection feature. Other downsides to the *keiretsu* model are corporate entrenchment, loyalty bias, and group thinking triggering scandal and fraud.

Other Governance Approaches: Technologies

Technology governance is another issue that is on the OECD's agenda. In this context, "'governance' does not refer just to regulation, but to a multitude of institutional and normative mechanisms to steer technology development" (OECD, n.d.). Technology governance consists of norms and physical and virtual architectures that manage risks and benefits. When used correctly, technology can increase transparency, improve efficiency, and encourage participation. The current challenge in this area has been how to protect consumers and society in the era of artificial intelligence, blockchain technology, online business platforms, and self-driving vehicles.

Another area where technology could add benefit is in improving investment transparency. Since an investor's return holds the key to governance decisions, Zhu (2019) proposed stock price informativeness may reduce the manager's opportunity to trade on their privileged information for personal gain and, thus, reduce the flaw of agency theory. Her empirical study integrated big data, such as online consumer transactions and satellite images for car counts at parking lots, into consumer product firms' stock price and announcement. These two types of data improve stock price informativeness, which allows firms to better project future earnings. When this projection is quickly and efficiently incorporated into current reporting, the increased transparency reduces insider trading activity. The increased transparency also has a positive effect on investment decisions. Investors who have access to these alternative data can be more selective in their investment choices. Transparency would not reduce their opportunity to earn a better return. The increased investment effectiveness will also reduce agency problems.

4.3 The Concept of Control

Corporate governance is not only a directive framework, but also a controlling one. Let's explore the aspects of **control** by looking at what it is, why it is needed, and how to exercise it within the framework of governance.

Control
This can be accomplished through owning a subject, holding possessions, and gaining feedback from an action.

Control in the psychological sense represents two underlining concepts: ownership and physical power (Scorolli et al., 2018). The owners of an object—be it a cup or a house—have the right to do anything with the object themselves or to hire another person to perform the task on their behalf. Ownership gives the owner the right to control the object, whether in person or remotely. The physical possession of an object is another form of control without ownership. Basketball players gain control of the ball. They can direct the motion of the ball without contributing money to purchase the ball. Both "controllers" can direct the movement of the object regardless of their ownership. This type of control can be viewed as external control.

Another aspect of control is the sense in which control refers to "the feeling of controlling our own actions and, through them, external events" (Haggard & Chambon, 2012, as cited in Wen & Haggard, 2018, p. 603). We can call this type of control internal control. Internal control has unique characteristics: it involves a sense of agency through which people are in control of a series of actions performed to achieve a goal, and it is achieved through taking action and receiving effects. Hence, three integrated elements make internal control work: assigned responsibilities, authority to take action, and intended results achieved through action.

The same logic applies to corporate ownership and control. Corporate control should be observed from three angles: who owns the firm, how owners control the firm, and how non-owners gain a sense of control. Then, we should investigate how control impacts corporate governance. We want to know how owners or agents affect corporate conduct and the decision-making process. We are also interested in which kinds of internal control (governance mechanisms) would be most effective. In this section, we will focus on owner (agent) control.

Corporate Control in a Global Setting

Corporate control is strongly associated with investor protection: the better the protection, the more likely the protected party is to hold the controlling shares. Protecting minority shareholders from the dominant shareholders also produces a significant control relationship. In countries where unions are powerful and have strong employment protection laws, either families or the state tend to control the listed companies rather than letting them be externally controlled. Shareholders of listed corporations include families, listed firms, private firms, governments, banks, mutual or pension funds, venture capital, or others. Aminadav and Papaioannou's (2020) survey of 80,607 shareholders who invested in 85 countries in 2012 revealed that 46 percent of them are families, 31 percent private firms, and 15 percent mutual or pension funds. Usually, holding between 20 and 25 percent of the voting rights means having **control of the firm**. According to this rule, approximately 46 percent of the surveyed 26,843 firms in the same pool have controlling shareholders. Families and private firms also represented the top controlling groups.

Control of a firm
This can be achieved by owning 20 to 25 percent of shares or using network power of control when holding less than 20 percent of shares.

Firms without a controlling shareholder are widely held. Argentina, Greece, Italy, Lebanon, and Portugal have pervasive family control, while Australia, Ireland, and Taiwan have the least family-controlled listed companies. On a surface level, governments only hold a small percentage of stocks in an individual firm, but their ownership is substantial through network holdings. Government-controlled firms mostly exist in Russia, China, Brazil, and India.

Shareholders without apparent controlling power can be powerful. For example, "BlackRock, Vanguard, and State Street combined were the largest owners in 88 percent of the S&P 500 companies in the US" (Mizuno et al., 2020, p. 2), even though their shares are less than 20 percent in each firm. Using the network power index (NPI) to measure the power of hidden influencers whose shares are between five and twenty percent, the Chinese government, Royal Dutch Shell, and the Russian government were the top three shareholders of the top 20 high network control values among 49 million companies with investments of 69 million shareholders worldwide (including individuals, corporations, and governments) in 2016. The network shareholder ratio (NSR), "which is similar to the concept of 'integrated ownership' […] shows the sum of equity capitals of firms a shareholder owns directly and indirectly in the ownership network" (Mizuno et al., 2020, p. 14). The Chinese government, the Norwegian government, and the Johnson family were the top three shareholders of the top 20 NSR in 2016. Such network controlling power could effectively enable one country to influence the government or a specific industry in another country. Thus, minority shareholders take power over the majority. The common-sense corporate governance under the normal economic environment we have described could be altered. Both family control and government control are quite an important phenomenon.

Family Control

Family control of a business can take three forms: family governance structure (direct control), in which family members (principal) hold the majority of the board and executive positions; corporate governance structure (mixed control), in which family members occupy some key positions and outsiders (agents) occupy other executive positions; and ownership structure (agents–managed), in which family members do not hold any board or executive positions but hire outsiders to lead and manage the business (Gupta & Nashier, 2017; Camisón-Zornoza et al., 2020). Among the many reasons why families choose one option over another, two primary factors are financial performance and dynamic capabilities, both of which seek to ensure the sustainability, innovation, and long-term competitiveness. The question of which form is the most effective has long been subject to debate and research results have been mixed. Several recent studies may shed light on this matter.

The study of 748 family firms in the Spanish tourism industry reveals that the percentage of share capital and the percentage of family wealth do not impact the firm's dynamic capacities under ownership structure (Camisón-Zornoza et al., 2020). Ownership structure gives the agents the maximum authority to operate the business. In turn, the governance team achieves the owner's goal for organization survival and their personal goals to gain benefits/return. Family governance structure certainly produces a direct and positive impact on the development of dynamic capabilities while capable and committed family members regularly meet, sort out their differences, and implement strategies. This form of governance, however, may be interpreted as a close-knit operation. Participation and contribution to the organizational development from the hired employees and managers may be very limited. This leads to the implementation of corporate governance structure, in which family members and the hired management committee work together, allowing for more co-leadership. Co-leadership promotes participation and contribution from both owners and non-owners. It is more likely to produce positive effects on the business value creation and achievement of objectives.

In terms of which form of governance is the best for family firms, Gupta and Nashier (2017) reported that family companies perform worse than companies not owned by families in India. The family governance structure “enhance[s the] performance of family firms at low levels of ownership. However, as their shareholding becomes concentrated, the monitoring benefits of non-family promoters are lost” (p. 62). The opposite is true in Japan. Sakawa and Watanabel (2019) indicated that family-ownership improves both dividend payout and firm performance while pursuing firm growth. Family-owned firms tend to take a stewardship approach to corporate governance so that minority shareholders are not sidelined.

Government Control (State Ownership)

Since state-owned enterprises (SOEs) dominate the global equity markets and consistently gain network share power, the SOEs phenomenon cannot be avoided and, therefore, should not be ignored. SOEs not only greatly influence the political and economic horizon in Asia, but also in Europe, in the Americas, and around the world. This phenomenon should not be treated as a threat or controversy. Rather, it is an opportunity to inform the revision or development of policies and strategies in different countries and regions.

From an economic perspective, SOEs are not only important to a country’s overall economy but can also achieve better financial performance (Amin et al., 2019). SOEs play an increasingly significant role in the national GDP (gross domestic product). As of 2010, SOEs contributed 30 percent of the GDP in Brazil, 29.7 percent in China, and 20 percent in Russia. For non-G20 countries, SOEs contributed 33.7 percent of the GDP for Vietnam, 28 percent for Poland, and 26 percent for Thailand (Nem Singh & Chen, 2018). Additionally, the study of 252 state-owned and 6,503 non-state-owned firms from 12 of the G20 countries (excluding Australia, Canada, Japan, Mexico, South Africa, the UK, and the US due to unavailable SOEs data) revealed that SOEs had higher annual leverage and profitability from the years 2011 to 2015. The size of SOEs is generally larger than non-SOEs. This research also discovered that SOEs in lower-middle income countries carried less debt. This indicates that the governance in these countries is less developed than that in high-income countries.

From a socio-political point of view, SOEs serve as an indicator of reform and transformation, particularly when moving from socialism to capitalism (Pula, 2017). The post-socialist central-eastern Europe is one example of “‘capitalist’ SOEs that have survived the privatization process and emerged as robust competitive market players in their respective national economies and the region” (Pula, 2017, p. 330). This is particularly true for Slovenia, Poland, Hungary, and Czech Republic, where business privatization has failed. SOEs have saved the economy and some private businesses in these countries. Vietnam is another example of this, where SOEs are expected to play the leading role in the social task-driven economy. Government interference in SOEs is more due to the desire to establish economic stability and implement social policies than profit-seeking (Cong Phuong et al., 2020). This objective somehow leads to a lack of transparency and accountability within the SOEs due to the government's involvement. It could lead to unfair competition when both SOEs and non-SOEs compete for the same resources and support.

SOEs can be employed to implement reputation-building strategies. Evidence of this practice is seen in emerging countries' investments in industrialized countries, called outward foreign direct investment (OFDI) (Holtbrügge, 2018). The Chinese OFDI since 2001 is a good example. Most Chinese OFDIs are SOEs and companies with a strong state influence. In order to build a good reputation, OFDIs usually avoid hostile takeovers as an entry strategy and, instead, appoint host-country managers. Keeping a positive image is the priority. Under this strategy, Chinese SOEs usually receive financial support from the state, accelerated approval, and privilege to access governmental networks. The CEO's connections and relationship with the governments of both home and host countries are critical.

Favoritism toward SOEs certainly puts non-SOEs at a relative disadvantage. Issues such as inefficiency operation, lack of transparency, and bureaucracy have been ongoing problems within SOEs. Non-SOEs must dedicate more efforts to achieve the same outcome. This leads to non-SOEs adopting unconventional approaches to acquire the same privileges. SOEs create a corporate governance dilemma despite all their positive effects (Nem Singh & Chen, 2018). In response, the OECD (2015b) thus published its Guidelines on Corporate Governance of State-Owned Enterprises. These guidelines call for the equitable treatment of shareholders and other investors and disclosure and transparency. The current state of the implementation of these guidelines, however, is yet to be investigated.

SUMMARY

We studied the practical foundations of corporate governance regarding the issues of sustainability and social responsibility. Sustainability, CSR, and corporate governance have a convergent effect. Agency theory, stewardship theory, and systems theory dominate the application of corporate governance. The different approaches to corporate governance are strongly influenced by regional and country orientations despite the existence of international guidelines, such as those from OECD and ICGN. The Western approach is predominately the "comply or explain" model, except for in the US, where a rule-based model has been adopted. The Eastern model is represented by the Chinese mixed model and the Japanese *keiretsu* model. Both have strong relationship and connection-building elements. To have sound corporate governance, control must be established from the ownership level. Family-owned firms adopt the family governance, ownership governance, or corporate governance approaches. SOEs are also a rising phenomenon. The network controlling power they create cannot be ignored. The corporate governance dilemma created by SOEs should be further investigated and mitigated.

UNIT 5

MONITORING CONCEPTS FOR CORPORATE GOVERNANCE

STUDY GOALS

On completion of this unit, you will have learned …

- several corporate governance mechanisms.
- how these mechanisms are applied in governance systems.
- the corporate governance codes adapted by several countries.

5. MONITORING CONCEPTS FOR CORPORATE GOVERNANCE

Case Study

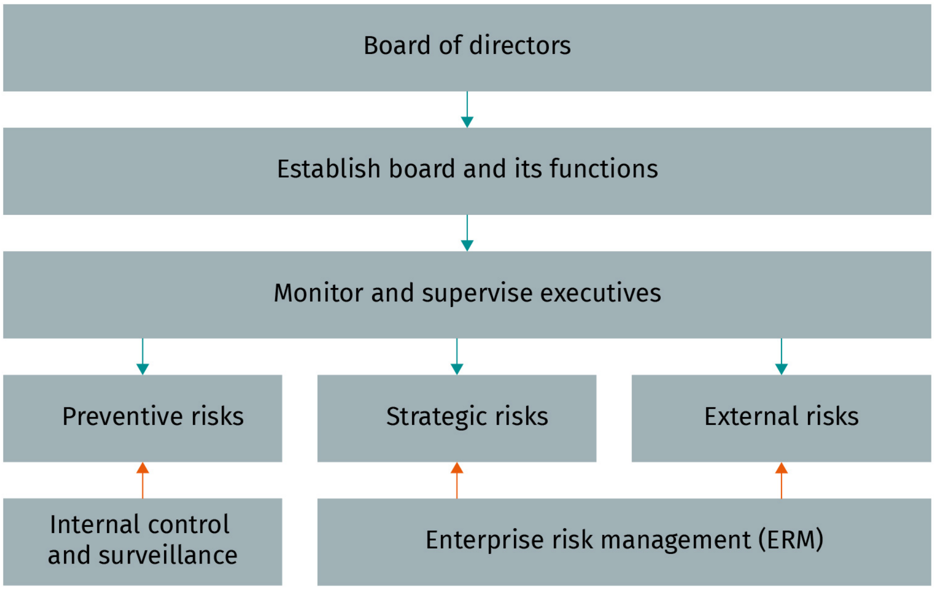
Surveillance is one the mechanisms used in corporate governance. Companies like Uber can use videos, recordings, and global positioning systems (GPS) to protect and track drivers and riders. In some countries, however, the surveillance tools may not operate as intended. There, wealthy people could register their vehicles and their names with Uber. They could order their personal driver to drive Uber riders when they do not need the car so that the driver and car would not be idle, generating extra income for the car owners. The drivers would not receive extra pay, but they would pay for the damage if an accident occurred (Firmino et al., 2019). The surveillance tools at this point would not be able to monitor the registered driver. It becomes a tool for the registered driver to monitor their own employees' productivity and the security of their own property. Thus, a loophole in surveillance exists. What is the effective governance mechanism, and how far should the governance measure go?

5.1 Governance Mechanisms

Governance mechanisms
These are measures put in place to support the effectiveness of governance. Their development is always based on the company's organization and structure.

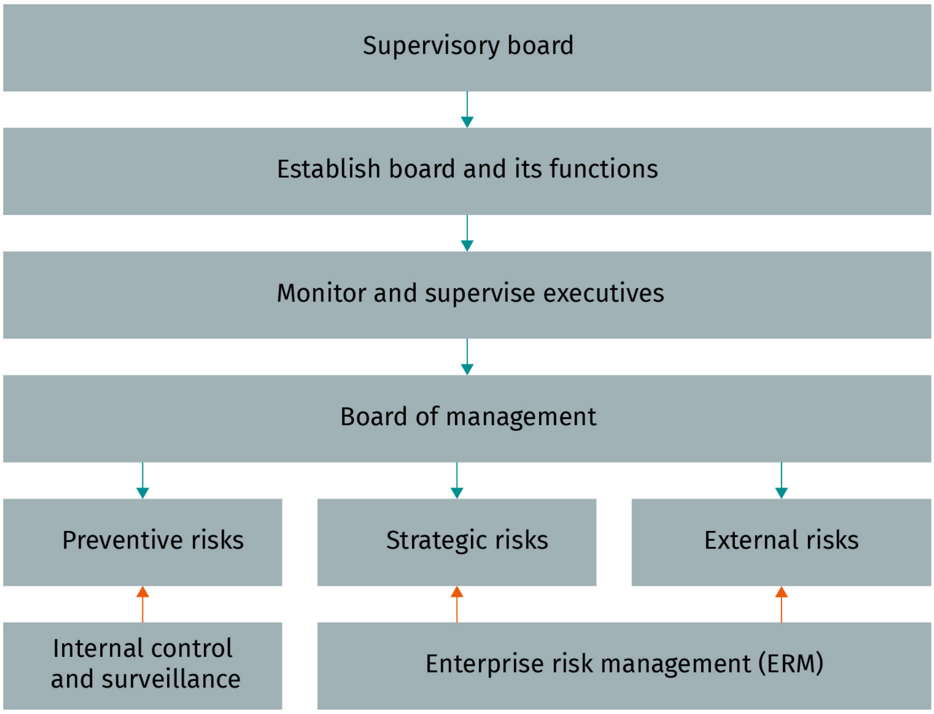
Governance mechanisms can be defined as "the formal and informal rules, practices, and processes that emanate from inside and outside a firm to direct and control firm behavior in a manner that balances and aligns the interests of its stakeholders, including owners, managers, customers, suppliers, governments, and communities" (Chrisman et al., 2018, p. 172). Corporate governance is the interplay of many related parties, the board, the executive leadership, the shareholders, employees, governments, auditors, and other stakeholders. These internal and external parties play integral roles for governance efficacy. Corporate ownership control, country legislation and regulation, and international guidelines serve as external governance mechanisms. Proper, functional boards, along with measures such as internal control, monitoring, surveillance, compliance, and risk management, form an internal governance framework to ensure all stakeholders adequately perform their duties and fulfill their responsibilities (Jankensgård, 2019). One-tier board and two-tier boards function similarly, except that two-tier boards include the supervisory board and the board of management.

Figure 5: Governance Mechanisms (One-Tier Board)



Source: Created on behalf of IU (2021).

Figure 6: Governance Mechanisms (Two-Tier Board)



Source: Created on behalf of IU (2021).

Governance, Risk Management, and Compliance (GRC)

GRC was introduced by the major accounting firm PriceWaterCoopers in 2004, which was also when enterprise risk management (ERM) was introduced. While ERM focuses on the framework, GRC focuses on the implementation of ERM through information systems (Papazafeiropoulou & Spanaki, 2016). GRC systems can be externally designed software or internally developed, integrated computer systems. They can be viewed as information technology (IT) controlling instruments that incorporate governance, risk management, and compliance elements in an interlinked network. The corporate finance, IT, and internal audit teams work together with GRC experts to customize and implement the system. If the controls and protocols are followed well, operational risks could be mitigated, and user activities would comply with the governance requirements. The system also enables information sharing in regards to GRC, improving transparency and effectiveness.

Establishing the Board and Its Functions

Theoretically, the members of the board of directors of a listed company are elected by the shareholders. The reality is that most shareholders do not have that much voting power. Nowadays, they may just accept or reject the chairman of the board, who in turn recommends the directors (Tricker, 2019). The chairman's nomination is often limited to the alumni and members of their network, contributing to a lack of diversity in directors.

These nominated directors could potentially lean toward the chairman's agenda. The "independence" could be just an illusion in a one-tier board structure. For this purpose, the two-tier board could be an advantage.

Once on the board, the directors perform their duties within their rights and powers while avoiding conflicts of interest. They are expected to bring in experience, knowledge and skills, and a network of resources so that they can exercise independent judgement and be the catalyst for change. Additionally, they monitor executives' activities and advocate for minority shareholders. The board's leadership does not stop here. Directors can also influence the company through the exercise of their power, e.g., the sanctioning power to remove or retain certain members. Their political power could sort favors and privileges for the company. Their ownership power could give more weight when it comes to decision-making. The likelihood of playing a power game would depend on the board style (Tricker, 2019). The professional board and representative board concentrate on the board tasks.

The percentage of professional directors has been on the rise since the implementation of the Sabanes-Oxley Act (SOX) in the US, increasing from 30 percent in 2002 to nearly 38 percent in 2014. A professional board tends to produce a lower likelihood of accounting restatements. Although they appear to be desirable, the market does not value professional directors for stricter monitoring because firms with a higher percentage of professional directors are more likely to engage in acquisition activities. Firms employing professional directors "exhibit significantly lower stock returns surrounding the transaction announcement date" (Wahid & Welch, 2019, p. 2240).

Monitoring

Cullen and Brennan (2017) defined monitoring as an action of observing the behavior of the agent through the direct or indirect review or observation of management performance, on-going performance management assessments, and service-level assessments. More precisely, "monitoring must precede control, but monitoring may occur on its own without subsequent control actions" (Cullen & Brennan, 2017, p. 1883). The terms **"monitoring" and "oversight"** are often used interchangeably. The difference is that actors in monitoring roles can take direct action to correct a wrongdoing, but people in oversight roles cannot take direct action and must go through a third party. Oversight is an extra layer of indirect monitoring.

Monitoring and oversight
Types of control, these are part of a board's key functions. Monitoring can direct a change, but oversight may not.

The monitoring and oversight of a CEO is one of the board's responsibilities. Monitoring could achieve a firm's performance improvements when SOEs are privatized (Poczter, 2016). Indeed, Poczter found that "monitoring alone increases productivity by 9—13 [percent]" (p. 919). Monitoring may not be effective, however, because an external, independent board of directors often relies on the internal executives for the operational information, which may not be prompt or complete enough to be sufficient (Chen et al., 2020). Hence, outsider directors require transparency to perform their duty effectively.

One of the board-led committees is the audit committee. The audit committee is another governance body that monitors a firm's performance by selecting appropriate external auditors and directing internal audits. Through quality audits, firms could gain and maintain public confidence in their financial reporting. This is particularly important given that many companies failed during the financial crisis. While it is not a mandate in many countries, US-listed companies have been required to have an audit committee since the implementation of SOX. Since 2003, 85 percent of DAX and MDAX companies have established audit committees. In 2006, audit committees became mandatory for all public interest entities in the EU (Vučković-Milutinović, 2019).

Risk Management

Risk management
This integrated and systematic approach mitigates or prevents different types of risks a business might encounter.

Business risks can be categorized into preventable, strategic, and external (Kaplan & Mikes, 2012). A firm must implement **risk management** practices in order to deal appropriately with risk. Preventable risks occur within an organization; defective products, biased vendor selection, or a lack of safety measures in operations could bring complaints and even lawsuits that would cost the organization's reputation and financial resources. This type of internal risk can be controlled and eliminated. The management of this type of risk usually falls to corporate risk management. Companies usually adapt internal control and training programs to mitigate preventable risks.

External risks refer to risks outside of a firm's control. Bad weather will likely cause shipping delays, political turmoil could interrupt operations, regulatory change could eliminate resources, or an economic crisis could lead to bankruptcy. A preventive strategy is possible only with sound foresight and data analysis. Enterprise-level risk assessment and management address this type of risk.

Enterprise risk management (ERM)
This is an internal process to identify risk events, manage risks, and provide reasonable assurance for the enterprise.

Strategic risks are internal risks that a business is willing to take. However, with proper management, this type of risk can be minimized. For example, the risk of a customer not paying could be reduced by running a credit check before the transactions. The risk of no production from oil drilling activities could be reduced by better exploration. **Enterprise risk management** (ERM) could also reduce the risk of agency and information problems the board encounters.

ERM aims at taking an integrated approach by the board to manage the firm's strategic and external risks to provide reasonable assurance of the firm's objectives (Jankensgård, 2019). ERM "is a process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives" (COSO, 2004, p. 2). ERM aims at two corporate governance problems. The first is to address the agency problem so that the executives take risk management actions seriously for the best interest of the investors. The second is the timely collection of risk exposure information to support strategic decision-making. Two popular international frameworks are currently in place: the Enterprise Risk Management-Integrated Framework by COSO (2004) and the International Organization for Standardization (ISO) 31000:2018 Risk Management —Guidelines.

Headquartered in New York, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) was organized by five financial professional organizations to establish frameworks and guidance on ERM, internal control, and corporate governance. The founding organizations include the American Accounting Association (AAA), the American Institute of Certified Public Accountants (AICPA), Financial Executives International (FEI), The Institute of Internal Auditors (IIA), and the Institute of Management Accountants (IMA) (COSO, n.d.). The COSO ERM framework outlines components such as event identification, risk assessment, risk response, and control activities. These components work strategically with financial reporting and compliance at all levels and all locations of the organization.

The risk management process of ISO 31000:2018 is similar to the COSO ERM framework (IRM, 2018). For the purpose of value creation through risk management, ISO 31000:2018 stresses dynamic and inclusive approaches with the consideration of human and cultural factors. All practices rely on leadership's commitment to continual improvement. The continual improvement is typical and echoes many themes from many other standards established by the Switzerland-based ISO.

Internal Control and Surveillance

While the board monitors executives, executives and managers adopt internal control and surveillance to govern the rest of the organization and lower ranking employees. Internal control is a process to provide reasonable assurance for the purpose of achieving reliability of financial reporting (AICPA, 2014). Firms establish control environments through monitoring, communication, risk assessment, and control activities (COSO, 2013). Control activities include placing qualified employees in the right positions, proper reviews, authorization hierarchy, and segregating duties that could cause conflict of interest or fraud, along with proper documentation of transactions. Surveillance, on the other hand, can be defined as the collection and processing of data for control and influence (Büchi et al., 2019). A camera above the cash register is a form of surveillance. Listening in on an employee's conversation with a customer on corporate 800-numbers is another form of surveillance. While internal control is perceived as a necessary and neutral approach, surveillance embeds distrust and may be perceived as a negative approach within an organization. However, on a larger spectrum, surveillance over an organization, a country, or a region could help gain insights of practices in order to evaluate or establish policies.

5.2 Governance Systems

When discussing corporate **governance systems**, the focus has been on the board structure effects: one-tier versus two-tier or outsider versus insider board systems. Recent studies, however, have expanded the focus to the functional effects of the systems, or what the governance system accomplishes for the organization in an international setting (Hromei, 2019; Aguilera et al., 2019).

Governance systems
These systems consist of both board structure and functionality.

One-Tier versus Two-Tier Corporate Governance Systems (Outsider versus Insider Systems)

We have evaluated both one-tier and two-tier systems on several occasions. We briefly summarize the major differences in the table below. It is important to note that the possibility of converging the two systems has been on the rise.

In addition to mature capital markets, outsider systems may also suit unregulated work markets, where “employees have relatively limited opportunities for decision and for expressing opinions at the company level” (Hromei, 2019, p. 170). Furthermore, a convergence trend has been observed at multinational companies (MNCs) in Germany, the Netherlands, the UK, and France. Because MNCs must adapt rules and regulations in a particular market, a convergent governance system is more “durable” to meet this need. Another advantage is that enhancing a firm’s performance can be sorted from the outsider system. Lastly, the accounting principles are similar in both industrial countries and emerging markets. One integrated governance system can work effectively to meet the reporting requirements. From Bayer’s governance system, we can observe the possibility of such “consolidation”.

Table 7: Main Differences between Two Corporate Governance Systems

	One-tier/outsider board	Two-tier/insider board
Board name	Board of directors	• Supervisory board • Board of management
Board member	Owners, shareholders, professional directors	Equal between shareholders and employees on supervisory board
Board focuses	• Independence • Capital market performance • Growth and strength	• Balanced relationships • Ownership structure • Stability and control
Risk management	• BOD direct monitoring • Reliance on ERM, internal control & surveillance, external audit • Rule-based approach	• Board of management monitoring • Reliance on both ERM and sub-governance systems • “Comply or explain” approach
Advantages	• High transparency • Rights and obligations are clear • Relationships and roles among stakeholders are clear • High degree of liquidity due to high degree of capital dispersion	• Satisfies the interests of several stakeholders • Sustainable economic activities • Responsibility and environmental programs

Disadvantages	• Financial market plays controlling role • Stock price becomes an important indicator of performance • Hostile takeover hurts stakeholder relationship	• Less transparency • Lack of protection for minority shareholders • Preferential treatment in lending • Slow take up of new opportunities
Adapted by	Anglo-American countries	Continental European and Asian countries

Source: Created on behalf of IU (2021), based on Hrome (2019).

Let us illustrate the structural aspect and the functionality aspect of a two-tier board governance system by evaluating the practices at Bayer AG. This company was chosen because its two-tier board governance system is rather dynamic and transparent.

Bayer's Corporate Governance System

Bayer AG (Bayer) is a 157-year-old well-known German pharmaceuticals company (MarketLine, 2018). It is among one of the Fortune Global 500 companies, with 103,824 employees and $51,807 million in revenue. Bayer's 20-member supervisory board consists of people from Germany, Austria, the US, and the Netherlands (Bayer, n.d.). Its board of management consists of five executives.

The Bayer Supervisory Board established six committees according to the German Corporate Governance Act and German Stock Corporation Act, namely: Presidential, Audit, Human Resource, Nomination, Innovation, and Glyphosate Litigation. The board of management is responsible for the company's three core businesses (crop science, pharmaceuticals, consumer health), along with the firm's finance function. Bayer's risk management system is illustrated in the figure below.

Figure 7: Structure of Bayer's Integrated Risk Management System (Two-Tier Board)

Supervisory Board	
Presidential Committee Audit Committee Human Resource Committee	Innovation Committee Glyphosate Litigation Committee Nomination Committee
Board of Management	
Bayer Assurance Committee	
Operations	Crop Pharmaceuticals Consumer Health Enabling Functions
Control and monitoring systems (ERM)	Crop Pharmaceuticals Consumer Health Enabling Functions
Process-independent monitoring	Internal Audit
Corporate principles, standards, and methods	

Source: Created on behalf of IU (2021), based on Bayer (2019).

While the supervisory board provides oversight and ensures control over the board of management, the latter is responsible for running the business. The Assurance Committee lead by the chief financial officer (CFO) reports to the board of management (Bayer, 2019). The company places control, compliance, and approaches to tax in their governance systems.

Control through ERM

Bayer includes all levels of employees in implementing corporate principles, standards, and tools in risk management. Risk owners use the Risk Assessment Matrix to identify risk events. The Bayer Risk Universe is used to categorize the risks. Both financial-oriented and non-financial risks, as well as environmental, social issues, human rights, corruption, and bribery are included in the risk assessments. Risks with a potential impact of greater than 5,000 million euro are high risks and examined by the Assurance Committee. For instance, social and macroeconomic trends are grouped as high risks because increasing life expectancy demands innovative treatments for disease and world hunger. If Bayer cannot keep up with the demand, its core businesses will suffer. Other level risks are evaluated by the risk owners to determine whether to avoid, reduce, transfer, or accept them. The risk early warning system, internal control system, and compliance management system are adapted to fulfill these objectives.

Compliance

Like many multinational corporations, Bayer has established its corporate compliance policy. Ninety-five percent of Bayer's managerial employees worldwide completed at least one compliance training in 2019. Two thirds of employees (excluding the acquired agriculture business) took part in a web-based training program in the same period. Bayer adapts "responsive marketing" for compliance with European Federation of Pharmaceutical Industries and Associations (EFPIA) Disclosure Code. Crop Science's Product Stewardship Commitment aligns with the International Code of Conduct on Pesticide Management issued by the Food and Agriculture Organization (FAO) of the United Nations. Proper reporting and disclosure measures are in place for compliance with the Consumer Product Safety Improvement Act (CPSIA) of 2008. Bayer also joined forces with Volkswagen, Allianz, and Badische Anilin und Soda Fabrik (BASF) to found DCSO (*Deutsche Cyber-Sicherheitsorganisation*) GmbH in 2015 to help its member companies improve their security architecture and detect and fend off cyberattacks.

Tax governance

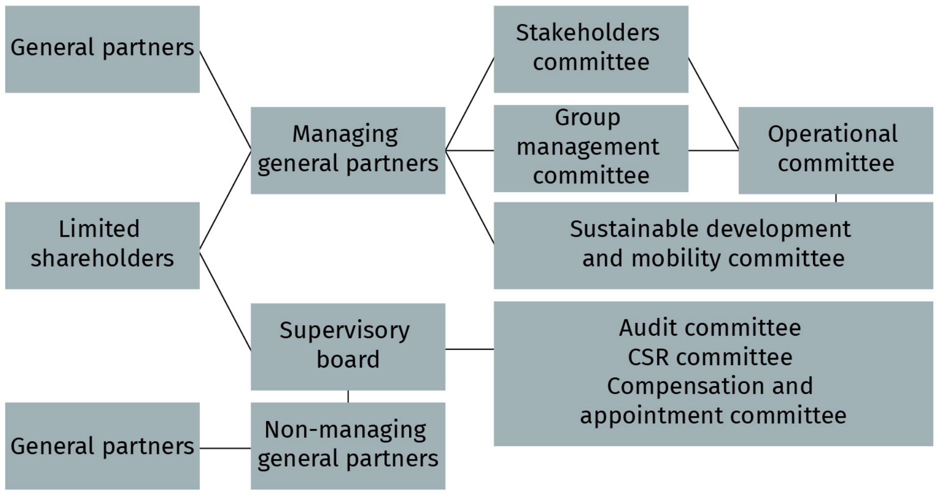
Unique to Bayer, tax governance is a stand-alone, heavily discussed governance mechanism. Bayer lays out its tax control framework to monitor tax risks and provide a tax directive and strategy. The framework involves the supervisory board, board of management, and external auditors. Bayer treats tax payment as a core element of their corporate social responsibility. Its approach to tax risk balances economic and operational factors along with reputation, social aspects, and shareholder value. The CFO and the head of group finance lead the Tax Compliance, Tax Project, and Tax Risk Committees to ensure tax transparency from the global to country levels.

The Unique French Corporate Governance System

Unlike the one-tier or two-tier systems in the rest of the world, French companies form unique and complicated corporate governance systems. This is largely due to the political economic environment in that country. Historically, the French government possessed significant control in large corporations (Yoo, 2019). Its ownership has been decreasing through decades of privatization. As of 2016, at the 20 percent threshold, "65 percent of 607 publicly traded corporations have family control" and, as of 2018, "17 firms on the CAC40 index are still managed or influenced by family control" (Yoo, 2019, p. 177). Yet, the government still maintains ownership in almost all **CAC40** companies. This background paved the way for French corporate governance. Companies rely on two governance bodies: institutions and graduates from elite French universities (*grandes écoles*). The corporate governance structure of French multinational manufacturer Michelin Group combines both individuals and representatives from institutions, as shown in the figure below.

CAC40
This is the market index used by Enronext Paris stock exchange.

Figure 8: Michelin Corporate Governance (Four-Pillar System)



Source: Created on behalf of IU (2021), based on Michelin (2020).

Michelin (2020) calls their governance system a four-pillar system. This system includes 1) limited shareholders from the public (94%), the Michelin family (4%), and employees (2%); 2) managing general partners; 3) non-managing general partners who are personally responsible for the company's debt; and 4) the supervisory board. The nine-member supervisory board consists of both independent and non-independent members. There is currently no employee representation in the supervisory board. Two employee representatives are planned to join the board. In addition to its distinguished structure, the board does not have monitoring or oversight functions; it only performs a control function. The managing general partners are fully responsible for the risk management through executives and several committees. It is indeed an *exceptionfrançais* style.

5.3 Corporate Governance Codes

Since the inception of the G20/OECD Principles of Corporate Governance (2015), regions have not developed their corresponding codes in the form of country collaboration due to the complexity in countries within each region. Rather, financial institutions published their codes to govern listed corporations within the regions they have operational offices. For example, the ICGN Global Governance Principles (2017) was endorsed by primarily Anglo-American, high-value investment firms. The International Finance Corporation's (2015) *A Guide to Corporate Governance Practices in the European Union* describe the corporate governance framework within the EU and highlight good European governance practices. Otherwise, countries establish their own governance codes and firms develop their codes according to their country requirements.

The G20/OECD Principles of Corporate Governance (OECD Principles)

The Organization for Economic Cooperation and Development (OECD) Principles have been an international benchmark for policy-makers, investors, corporations, and other stakeholders since they were first published in 1999. This set of principles focuses on financial and non-financial publicly traded companies. Although they have been used as a benchmark outside of G20 countries, the acceptance of the OECD Principles means they are applied differently in many countries, and convergence among those independently developed guidelines is not guaranteed. The Principles cover a range of topics including stakeholder roles; disclosure and transparency; and board responsibilities.

The ICGN Global Governance Principles (GGP)

The International Corporate Governance Network (ICGN) uses the OECD Principles as a basic framework but develops them further according to the interests of big investment companies. The GGP applies to ICGN members who manage more than $26 trillion in assets. GGP applies to investors in over 45 countries. Together with its Stewardship Principles, the ICGN promotes its position that investors and companies are both responsible for preserving and enhancing corporate values and contributing to the overall sustainability. The ICGN's eight-principle GGP outline is as follows:

1. Board role and responsibilities
2. Leadership and independence
3. Composition and appointment
4. Corporate culture
5. Risk oversight
6. Remuneration
7. Reporting and audit
8. Shareholder rights

The IFC Corporate Governance Practices in the European Union Guide

This guide is intended for EU member states, Eurozone countries, EU candidate countries, the European Council countries, and countries seeking to increase trade with or attract investment from European countries. The guide addresses the company, owners, board, management, stakeholders, corporate responsibility, and ethics within the European context. The principles of good governance in European companies entail the following: delegation of authority, checks and balances, team decision-making, accountability, transparency, the prohibition of conflicts of interest, and the alignment of incentives with the long-term interests of the company.

Subsequently, countries develop their codes of corporate governance in association with their country's distinct characters. The US, the UK, India, and the UAE mandate compliance. France, Germany, the Netherlands, Norway, Switzerland, Australia, Brazil, China, and Russia are following the "comply or explain" practice on either a disclosure or voluntary basis (Weil, Gotshal & Manges LLP, 2014). The codes from these thirteen countries are comprised of ten common themes (or key agreed principles). These are as follows:

1. Board responsibility for governance
2. Corporate governance transparency
3. Director competency and commitment
4. Board accountability and objectivity
5. Independent board leadership
6. Ethics, integrity, and responsibility
7. Attention to information, agenda, and strategy
8. Protection against board entrenchment
9. Shareholder input in director selection
10. Shareholder communications

Usually, the security exchange (or stock exchange) or a similar agency of these countries issues the codes. In Germany, the Netherlands, and Norway, codes are issued by the designated corporate governance board (or similar); in France, they are issued by the France Enterprises Movement (MEDEF) and the Association of France Private Enterprises (AFEP).

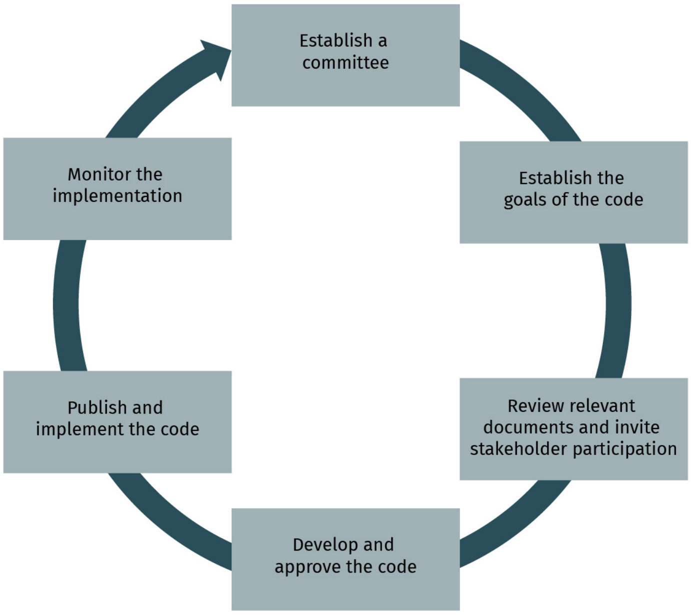
Instead of developing an individual corporate code, German companies adapt the German Corporate Governance Code. They make an annual declaration on compliance and issue governance reports. In addition to compliance with several federal regulations (e.g., SOX), major US Fortune 500 companies led by the CEOs of Walmart, Apple, Cisco, and Johnson & Johnson, among others, developed the Principles of Corporate Governance 2016, which were adopted by more than 200 Business Roundtable member companies (Business Roundtable, n.d.). On the other hand, China and the OECD jointly developed the Corporate Governance of Listed Companies in China (OECD, 2011). The China Securities Regulatory Commission is responsible for the nation's self-assessment.

Despite having many layers of codes and guides, companies are not immune from misconduct. Uber's Corporate Governance Guidelines do highlight many essential governance elements that go above and beyond the federal guidelines. Uber's codes include risk oversight, ethics and conflicts of interest, and limits on outside director activities, as well as CEO evaluation, succession planning, and communication with stockholders (Uber, n.d.). However, one of Uber's largest investors sued former CEO Travis Kalanick for interfering with the new CEO search (Balakrishnan, 2017). Uber also hid a security breach in 2016 from its investors (Isaac et al., 2017). Although it had been a private company until 2019, its governance history has been on the governance "lesson learned" list (Silverman, 2020). Reviewing and revisiting the code seems to be necessary when a firm changes its ownership structure. The scale of the operation may also require upgrade of the code. Otherwise, the code may become a meaningless document if it does not fit or is not being implemented.

Developing a suitable governance code takes commitment and strategic planning. The time to create a code ranges from a few months in a large organization to eight months at the country level (Global Corporate Governance Forum, 2005). It is possible to take months to develop a code for a large organization. A firm may like to form a committee and appoint a project manager in charge of the logistics, collaboration, and time keeping of the development. The firm will want to establish the goals of the code, as well as its scope. They want to consider, perhaps, incorporating legal requirements, provisions, and the recommendations from regulatory agencies and governance organizations. They must prepare to deal with internal and external difficulties. Some stakeholders may not support the initiative, leading to disagreement, or funding could be insufficient. These possibilities require the firm to consult with stakeholders and possibly engage their participation. Experts and consultants can be invited to guide the process.

At the researching and drafting stage, the committee will first want to absorb the relevant governance documents and stakeholders' inputs, and review the current code. Afterwards, they will decide the new code structure, elements, style, and format. They will appoint and designate a drafter for the drafting tasks. Upon approval, the organization will take steps to launch the new code by utilizing appropriate launching, distribution, and communication channels. A timeline for implementation and monitoring should be established and adhered to. The figure below illustrates the code development cycle.

Figure 9: Cycle of Corporate Governance Code Development



Source: Created on behalf of IU (2021).

Furthermore, the development of a uniform code for international corporate governance (ICG) is also evolving, aiming to provide guidance for MNCs that operate cross-country or cross-continent (Aguilera et al., 2019). Should the company adopt the home country's code throughout or customize to the host country? Such customization may lead to inconsistency and conflict among subsidiaries. Majority owners could be from different countries as well. How to balance the requirements from each country is also a tough decision. An ICG code may reduce bias and bring consistency within one MNC as well as all MNCs. The choice of board structure may be flexible to meet the need of cross-border operations under an ICG code. The uniform code could formally bring the human rights and labor issues to the emerging markets. Thus, the MNC operates on a consistent value framework.

SUMMARY

Effective corporate governance utilizes clear governance codes, functional mechanisms, and integrated systems. International codes developed by the OECD and ICGN are the fundamental principles of governance. Regional codes follow the spirit of international codes and customize them to fit the diverse culture and political environment. Countries either mandate the compliance with the national code or take the "comply or explain" approach. Firms select suitable board members and establish their duties to carry out the monitor and oversight functions. Although shareholders elect the board through networks, professional directors are sometimes hired. The board ensures that internal control and surveillance are in place to eliminate preventive risks and that the ERM framework is established to mitigate the external and strategic risks. Currently, companies take a one-tier, two-tier, or four-pillar board structure. Each form has its disadvantages when fulfilling its governance functions. This leads to inconsistency in governance practices for MNCs. The evolving code of international corporate governance may eventually be able to propose a more advantageous solution for them.

UNIT 6

COMBINING BUSINESS ETHICS AND CORPORATE GOVERNANCE

STUDY GOALS

On completion of this unit, you will have learned …

– how business ethics and corporate governance interact.
– the building blocks of ethically oriented corporate governance.
– the challenges management faces in the context of corporate governance.
– some approaches that connect leadership with ethics and corporate governance.

6. COMBINING BUSINESS ETHICS AND CORPORATE GOVERNANCE

Case Study

When the Volkswagen (VW) Jetta TDI received the “Green Car of the Year” award from the *Green Car Journal* in 2009, no one expected the company to return the award six years later (Green Car Editors, 2015). The event was triggered by yet another corporate cheating scandal that cost at least $35 billion in fines, litigation costs, damage pay-offs, and associated expenses. Former executives have also been tried for fraud, market manipulation, embezzlement, and competition law violations (Deutsche Welle, 2020; Taylor, 2020).

After the award ceremony, the International Council on Clean Transportation (ICCT) wanted to know how some European diesel cars like Jetta met the strict US nitrogen oxide (NOx) emission limitations while measuring higher emissions in Europe (Poier, 2020). In 2014, they found that VW had installed a deception software in the car to cheat on the road test. A similar trick had cost renowned diesel manufacturers Caterpillar, Inc., Cummins Engine Company, Detroit Diesel Corporation, Mack Trucks, Inc., Navistar International Transportation Corporation, Renault V. I., and Volvo Truck Corporation $83.4 million for environmental law violations in 1998 (EPA, n.d.-b).

Why didn’t VW learn its lesson? How can firms learn a lesson in ethics?

6.1 Linking Business Ethics and Corporate Governance

In terms of organizational wrongdoing, Schmidt (2020) have a couple explanations: a) learning is missing from the current ERM model, and b) there is lack of global standards. Current governance policy has its flaws. Specifically, “worldwide there is a lack of consistent standards for measuring the overall impact of companies, covering economic, environmental and social aspects of business activities along the value chain” (Badische Anilin und Soda Fabrik [BASF], n.d., Reporting our value section, para. 1). The VW diesel scandal not only cost the company financially, but also damaged its brand value and Germany’s high car manufacturing reputation. VW was the world’s eighteenth most valuable brand pre-scandal; it became twenty-fifth in 2020 according to BrandFinance (Colvin, 2020). Given the fact that VW is Germany’s largest company, the damage to the value of the German brand is incalculable. The company eventually had to lay off 30,000 employees worldwide due to the scandal. Virtually everyone in the value chain suffered.

Individual, group, and organization ethical alignments were certainly missing at VW. The internal design and development of the deceptive device and its installation in the car required reviews, evaluations, and approvals at many levels. Each level of management knew what the device was for; yet, no one objected to the wrongdoing. The fact that the executives pointed fingers in court is another indication that they knew what VW did was wrong. At a minimum, the designers and approvers did not practice the VW values of integrity and ethical behavior. How can a firm learn a lesson in ethics?

Argyris (1991) cautioned that smart people can be their own enemies if they let their egos block their path for further learning. By doing so, people are trapped in single-loop learning, where the learning is simply for solving a problem. He proposed **double-loop learning**, which is learning by reasoning why something negative happened and how to modify actions to prevent it from happening again. In VW's case, they did not demonstrate that they had learned to connect ethics with good governance in their decision-making. If they did have knowledge of previous unethical cases, they certainly did not take effective preventative actions to avoid another unethical instance.

Double-loop learning
This is informed learning or learning by reasoning.

This situation represents another learning deficiency: the disconnect between knowing and doing. Hence, to link ethics with corporate governance, we need to know why it is critical and how to make the connection. One reason that business ethics and corporate governance should be and are closely connected is that some ethical principles are soft laws in nature (Şahin, 2018). For example, insider trading, bribery, and excessive emissions are morally wrong and are prohibited by laws because they are against public economic interests.

Another reason for connecting ethics with governance is that not every step of business activities is regulated. People must rely on a firm's and on their own ethical principles to judge the good and bad. If the firm intentionally links their values with their governance framework, the company has a better chance at performing both ethically and effectively. In general, businesses could take actions in certain areas to address the disconnect between ethics and current governance practices.

Action 1: Integrate responsible innovation into responsible corporate governance

Responsible innovation concerns the ethical and social implications of scientific innovation where the product is ethically acceptable while meeting the needs for sustainability and societal desirability (Scherer & Voegtlin, 2020). Responsible governance requires governance structure and a process to facilitate the responsible innovation.

Action 2: Be pro-active

Corporations can go above and beyond the imperfect governance systems by incorporating ethical elements into governance systems, such as decision-making processes (Wynn-Pope & Lumsden, 2020). When making a decision, ethical fitness can be incorporated into the "checklist". Ethical evaluation embedded at every level is the key to ensure that the framework is effective.

Action 3: Specify the ethical duties for the directors

Directors cannot ignore the negative impact on their organization of a corporate culture poor in ethics and the consequences of a bad reputation. Their business judgements must balance environmental, social, governance, and economic-related issues. Obeying the law, not being misleading or deceiving, and being fair are some of the considerations that should influence their judgments.

Action 4: Establish a system of ethical learning

Many global conglomerates, such as VW, have an internal academy for technical and business learning. Ethics must be a part of this systematic learning. Ethical practice must be embraced by the leadership. The company must put concrete learning processes in place. Ethical leadership needs to be reinforced, refreshed, and demonstrated regularly. Ethical learning applies to everyone in the organization.

Value management system
This system consists of identifying corporate values, setting behavior expectations, and measuring and evaluating practices.

To address the flaws in current corporate governance, an ethically oriented governance framework should be established in a normative system rather than a patchwork. Value alliances can be explored from within an organization and beyond the organization. Shared values and ethics can be accomplished by a **value management system** that seamlessly connects ethics principles, values, and other basic ethical issues with compliance management and CSR management (Wieland, 2014). Value management starts with identifying values that are pertinent to the business. Quality, creativity transparency, respect, integrity, fairness, and responsibility are some of the values that are important to a firm's morale, performance, and cooperation. Once the values are clear, behavior expectations are determined and incorporated into the code of ethics and corresponding policies for employees to live by daily at the workplace. Values become actionable, visible, and eventually, verifiable (Wieland, 2014). The figure below resembles a typical value management system.

Figure 10: Value Management System

Source: Created on behalf of IU (2021).

Values-driven management evolves from the value management concept. Values-driven management is the practical realization between a company's original and ethical values. It is a way the company adapts to its environment, achieves integrity, and respects stakeholders (Rendtorff, 2019). Here, internal development and external influence work in parallel to promote the organization's values and ethics.

6.2 Developing an Ethically Oriented Corporate Governance

Singer and Ven (2019) distinguished corporate governance for in-house administration and market transactions. This separation is important because firms must take different approaches to internal governance and external alliances for effective governance. Internally, current governance frameworks do not specify the ethical value connection with many initiatives that firms have undertaken, regardless of whether it is a one-tier, two-tier, or French four-pillar system. Position power and hierarchy could play a big role in ethically oriented governance.

Ethically oriented corporate governance
This framework combines both value management systems and ERM with talent management and learning management.

Compliance, to a certain extent, could be required and not be a choice, if the company insists on it. Thus, **ethically oriented corporate governance** should be communicated, taught, demonstrated, and evaluated throughout the organization. Externally, firms interact with external primary stakeholders through transactions. All participants in these transactions must abide by laws, regulations, and socio-economic expectations transnationally, while following the contracts. Ethically oriented corporate governance could be organized as in the table below.

Figure 11: Ethically Oriented Corporate Governance

<table>
<tr><td colspan="4">Value management system</td></tr>
<tr><td colspan="2">• Value orientation
• Corporate culture
• Leadership</td><td>• Code of ethics
• Stakeholder communication
• Measures and evaluations</td><td>Strategic level value management</td></tr>
<tr><td>Compliance management</td><td>CSR management</td><td>Sustainability management</td><td>Operative level Value management</td></tr>
<tr><td>Compliance office</td><td>CSR office</td><td>Sustainability council</td><td>Organization</td></tr>
<tr><td>OECD Guide & Code of Conduct</td><td>UN Global Compact</td><td>Internal guidelines</td><td>Standard</td></tr>
<tr><td>• Compliance process
• Compliance conduct
• Compliance guidelines, directives, processes
• Audit
• Compliance organization</td><td>• Lead process
• Quality management
• Contract management</td><td>• Management of the value creation chain
• Energy, water, waste management
• Green products</td><td>Areas</td></tr>
<tr><td colspan="4">Talent management</td></tr>
<tr><td colspan="4">Learning management</td></tr>
</table>

Source: Created on behalf of IU (2021), based on Wieland (2014).

Here, ethically oriented governance begins by integrating a value management system. This system sets the tone for corporate value proposition, ethical conduct, and measurements. Through dialogue and communication, values form collaborations and alliances internally and externally, particularly with stakeholders such as auditors, environmental agencies, and advocate groups who monitor a firm's products and services by applying higher or different moral standards.

A company's compliance management system serves as a main taskforce for internal controls, monitoring, and compliance. CSR and sustainability management would ensure the firm meets its obligations to the society and community in order to conduct business, manage risks, and fulfill a firm's social responsibility, ethically. Learning management is to make sure that knowledge is transferred within different locations and from generation to generation. Talent management will develop and reward employees based on the corporate expectations. Specifically, several BASF's Value to Society (BASF SE, n.d.-b) approaches may offer practical solutions.

BASF takes a macro-perspective approach in production and innovation by going beyond the traditional input-output model. They incorporate important elements such as outcome, impact, and societal benefits and costs to the business performance report. These prevent short-term focus practices and encourage long-term orientation. This orientation directs employees' attention to holistic, dynamic solutions rather than quick fixes; financial and reputational gains rather than simple, annual monetary bottom lines; and honesty rather than deception.

The company evaluates and measures economic, social, and environmental aspects of its operations. Net income and amortization are the only two economic criteria. For social responsibility, four criteria are included: taxes, wages and benefits, human capital, and health and safety. Within the environmental aspect, six criteria are covered: air emissions, greenhouse gases, land use, water consumption, and water emissions. The spectrums of its business evaluation put the company in a lead position as a socio-economic minded, balanced enterprise. These measures are illustrated in the figure below.

Figure 12: BASF Integrated Economic, Social, and Environmental Measures

Category		Economic		Social		Environmental
Elements		Net income Amortization Depreciation		Human capital Wages Health and safety Taxes		Greenhouse gas Waste Water consumption Land use
Overall corporate performance	=	Positive or negative balance	+	Positive or negative balance	+	Positive or negative balance

Source: Created on behalf of IU (2021), based on BASF SE (n.d).

The company expands evaluations and measurements to direct and indirect suppliers and direct customers by applying the same three aspects. By visualizing the positive and negative impacts, suppliers and customers are encouraged to align with the company's value propositions for society. The transparency enables informed decision-making and demonstrates the ethical character of its actions.

The expansion from internal governance to a transnational value chain inclusion opens a new field that global corporate governance has yet to explore. Global value chain (GVC), by definition, encompasses "the full range of activities that multiple firms in multiple countries undertake to bring a product or service from its conception to its end use" (Gereffi & Fernandez-Stark, 2016, as cited in Singer & Ven, 2019, p. 326). The complimentary nature among the stakeholders makes collaboration and compromise much easier than among competitors. Thus, the lead firm (such as BASF) could orchestrate the aligned value and ethical practices.

BASF further established a Value Balancing Alliance together with some renowned enterprises like the BMW Group, Deutsche Bank, Mitsubishi Chemical, Novartis, the SK Group, and the big four international accounting and consulting firms in 2019 (Value Balancing Alliance, n.d.). This organization carries the same Value for Society spirit aimed at empowering decision-makers with standardized monetized value models to create and protect long-term tangible and intangible values for human well-being while adding economic value.

The SK Group's Social Value Implementation System (SK network, n.d.; SK network, 2020) very much resembles the framework of ethically oriented corporate governance and the value balance concept. The happiness of members and stakeholders are supported by "Healthy Life" and "Good Production & Consumption". Values are realized through innovation, management system improvement, and compliance. Social performance is measured by subtracting social cost from social benefit. Social benefit includes indirect economic contribution (employment, dividends, and tax payment), social values generated from development/production/sales (environmental and social), and social contributions (CSR program, donation, and employee volunteering). Social cost includes water resources consumption, greenhouse gas emission, and waste discharge. These measures, together with their economic value measures, form the **value-balance double bottom line**.

Value-balance double bottom line
This value balancing approach evaluates the operational, social, and financial impact.

6.3 Leadership in the Context of Ethical Corporate Governance

Although business activities have grown more sophisticated throughout centuries, corporate misconduct has not stopped, and ethical dilemmas continue to face corporate leadership. Leadership has, unfortunately, failed the challenges numerous times. Now it is the time to discover what leaders can do and how they can be successful in leading an ethical corporate governance.

Character
The mix of virtues, personality traits, and values that enable leadership excellence is called character.

First and foremost, consider the board leader's **character**. Board members are instrumental in setting the tone of ethical governance, whether they are on a supervisory or management board. Their character is the key ingredient in decision-making and action (Seijts et al., 2019). Character is an "amalgam of virtues, some of which are personality traits and some which are values that enable leadership excellence" (p. 229). Character is both inner beliefs and demonstrated behaviors and practices. Thus, character is seen, mimicked, and acted upon.

Each decision made by a board represents the collective characteristic of said board. Decisions let others know what the board values, stands by, and cares about. Some of the plausible character traits that we have heard many times include courage, accountability, justice, integrity, and humanity. Some are not so common but necessary, such as transcendence and humility. Possessing humility enables a person to be self-aware and vulnerable. This, in turn, makes it possible for people to respect others sincerely and continually learn from others. Continuous learning makes them more future-oriented, purposive leaders, and a part of the transcendence. Since character can make tangible differences for the organization, it is critical to recruit qualified members with the desired character as a pro-active measure rather than question their character in a time of crisis.

Secondly, practice transformational leadership and ethical leadership (Elmasry & Bakri, 2019). Transformational leadership empowers employees. Employees are encouraged to be innovative and think outside the box during problem-solving processes. Active participation boosts employees' confidence and inspires employees to keep learning. A supportive climate opens two-way communication. Employees are more engaged in achieving corporate vision and organization objectives (Elmasry & Bakri, 2019). On the other hand, individual character must relate to the organization. The right values must be embedded within the organizational culture and the value management system. This enables the alignment of moral values throughout and from top to bottom within the organization. At this point, individual moral competence is integrated with economic and organizational competencies (Wieland, 2014). We can speculate that value-alliance and double-bottom line are the outcome of ethical and transformational leadership at play.

Thirdly, consider human leadership (Spitzer, 2020). The rationale behind this proposal is the belief that people follow a true leader because they choose to do so voluntarily. Whether it is a rule- or "comply or explain"-based governance principle, there is a limitation to what the guidelines can cover and to what extent an organization should be governed by outsiders. Instead of stressing more detailed regulations, human leadership promotes integrity at all levels of an organization. When everyone chooses to comply with laws, follow the guidelines, and act on ethical judgement voluntarily, they have reached an ideal stage of ethically oriented corporate governance.

Some leaders have not only passed the "test", but also thrived and become pioneers in ethical governance. Let us draw our attention to Jochen Zeitz. Zeitz was the youngest ever CEO of a German company when he became CEO of Puma at age 30 in 1993. During his eighteen-year tenure, he turned the nearly bankrupt business into one of the world's top three sports brands (Benson, 2019; Harley-Davison, n.d.). In addition to drastically increasing the company's share price, he created Puma's Environmental Profit and Loss (EP&L) account. The company has been measuring and addressing its operational air pollution, carbon emission, land use waste, and water pollution since 2011. The efforts led to a continual decreasing EP&L value per revenue from 2013 to 2018 (Puma, n.d.). Nowadays, the EP&L account has been adapted by a UK paramedical company, Novo Nordisk, Danish Apparel Consumption, Swedish Sollentuna Municipality, Arla Foods of Denmark, and Philips of Netherlands (LCA Consultants, n.d.; Philips, n.d.).

Zeitz's legacy went beyond Europe. He established the Long Run Initiative (LRI) aiming at making "business, nature, and people work harmoniously together for a sustainable future" (The Long Run, n.d.). LRI focuses on conservation lands, improving community life, celebrating cultural diversity, and investing in these philanthropies. Their Global Ecosphere Retreat (GER) standard is recognized by the Global Sustainable Tourism Council and is a leading sustainability standard.

Leaders like this can lead and have led positive changes for the companies they serve and for the community they care about. The young and ambitious Zeitz transformed Puma. Today, he continues to set examples of leadership excellence. Imagine, some CEOs are in the court room justifying their misconduct, while others are sharing their visions and making a positive impact in their country and around the world. Where would you rather be? Whom would you rather be?

SUMMARY

The Volkswagen emission scandal is a wake-up call to corporate leaders. They must address the issues of ethical learning. Ethics can be learned and should be learned with the mindset of why wrongdoing occurrs and how to prevent it from happening. Corporate governance guidelines are not “one size fits all”. The gap between guidelines and practices can be filled by taking proactive action and establishing a value management system within organizations. Eventually, the value management system and corporate governance framework come together to form an ethically oriented corporate governance. The effectiveness of such a system needs ethical leaders. Leaders with desired characters are recruited at the board level. They are expected to practice transformational and ethical leadership with financial and societal benefits in mind.