# BUSINESS ETHICS AND CORPORATE GOVERNANCE TERMINOLOGY AND CONCEPTS

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|---|---|
| Timeframe: | Minimum 20 hours |
| Learning outcome: | • Critically explain corporate governance and business ethics terminology and concepts. |
| Prescribed reading: | • Financial Reporting Council (FRC). 2012, *The UK corporate governance code*, European Corporate Governance Institute (ECGI), http://www.ecgi.org/codes/documents/cg_code_uk_sep2012_en.pdf (accessed 15 January 2014).<br>• Institute of Directors Southern Africa. 2009, *King III code of good governance for South Africa*, European Corporate Governance Institute (ECGI), http://www.ecgi.org/codes/documents/king3.pdf (accessed 15 January 2014).<br>• Ministry of Corporate Affairs, Government of India. 2009, *Corporate governance voluntary guidelines for India*, European Corporate Governance Institute (ECGI), http://www.ecgi.org/codes/documents/cg_voluntary_guidelines_2009_india_24dec2009_en.pdf (accessed 16 January 2014). |
| Recommended reading: | • Crowther, D. and Seifi, S. 2010, *Corporate Governance and Risk Management*, [e-book] 1st ed., Bookboon.com, http://bookboon.com/en/corporate-governance-and-risk-management-ebook (accessed 20 August 2012).<br>• Holme, C. 2008. 'Business Ethics – Part One: Does it matter?' *Industrial and Commercial Training*, Vol. 40 (5), pp.248 – 252, http://www.emeraldinsight.com/journals.htm?issn=0019-7858&volume=40&issue=5&articleid=1733323&show=html (accessed 9 April 2014).<br>• Kane, D. 2007, 'The real value of corporate governance', *Business Review*, 9(1), 58–61, http://www.uabr.auckland.ac.nz/files/articles/Volume13/v13i1-the-real-value-of-corporate-governance.pdf (accessed 21 August 2012).<br>• Stallings, K. nd, 'Business and morality', http://www.kenstallings.com/Columns/Business%20and%20Morality.htm (accessed 9 April 2014).<br>• Technip, 2011, 'Ethics in Business', http://www.technip.com/sites/default/files/technip/page/attachments/Ethics_Compliance_booklet_EN_final.pdf(accessed 9 April 2014)<br>• Younkins, E.W. nd, 'The reality and morality of business', http://rebirthofreason.com/Articles/Younkins/The_Reality_and_Morality_of_Business.shtml (accessed 21 August 2012). |
| Section overview: | There is no universally-accepted definition of corporate governance. Many different definitions of the term can be found in academic writings and in various international codes and reports. We begin this section by reviewing some of these definitions including current issues.<br><br>Given the centrality of business ethics, morality and values to our discussions on corporate governance, we explore these broadly and provide additional recommended readings.<br><br>This section concludes with the importance of corporate governance. |

## What is Corporate Governance?

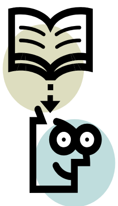
There is no universal agreement on the definition of corporate governance. However, Goergen (2012) points out that a country's culture, political orientation and its legal system explain some of the differences that we see in corporate governance today.

The governance of corporations can be on a:

- Statutory basis
- Code of principles and practices or
- A combination of the above two.

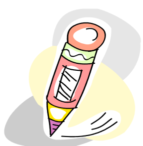
For example, the United States has chosen to codify a significant part of its governance through the Sarbanes-Oxley Act (SOX). Their view is **'comply or else'**, and there are legal sanctions for non-compliance. Many other countries, including those in the EU, have opted for a code of principles and practices on a **'comply or explain'** basis, in addition to certain governance issues that are legislated.

The King III Report compiled by the Institute of Directors South Africa (2009) argues that a 'one size fits all' approach is not logically suitable due to the wide range of business carried out by corporates and that the cost of compliance is burdensome (in terms of time and direct costs). However, "There is a link between good governance and compliance with law. Good governance is not something that exists separately from the law; it is entirely inappropriate to unhinge governance from the law" (Institute of Directors South Africa, 2009).



Is SOX (USA) an overreaction to Enron, WorldCom and similar case studies and has it resulted in ineffective and unnecessary legislation?

Consider the following definitions for corporate governance and reflect on the similarities and differences.



"A set of relationships between a company's management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring" (Canadian Corporate Governance Guidelines in OECD, 2013).

"Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place.

> The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship.
>
> The board's actions are subject to laws, regulations and the shareholders in general meeting" (UK Corporate Governance Code 2012 in Financial Reporting Council (FRC). 2012).
>
> "Good corporate governance practices are a *sine qua non* for sustainable business that aims at generating long-term value at all its shareholders and other stakeholders. Some aspects of corporate governance have been enshrined in the law that is administered by the Ministry of Corporate Affairs, SEBI and other sectoral regulators.
>
> However, a transparent, ethical and responsible corporate governance framework essentially emanates from the intrinsic will and passion for good governance engrained in the business entity" (India's Corporate Governance Voluntary Guidelines 2009 in Ministry of Corporate Affairs, Government of India. 2009)

Notably, the Canadian Guidelines state that effective corporate governance is not only the result of 'hard' structural elements, but also 'soft' behavioural factors driven by dedicated directors and management who perform their duties faithfully with due regard to the care of the institution. This intrinsic will is also emanated in India's guidelines.

Read the following three governance documents and then complete the task that follows.

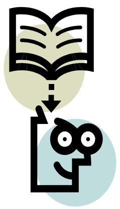
- Institute of Directors Southern Africa. 2009, *King III code of good governance for South Africa*, European Corporate Governance Institute (ECGI), http://www.ecgi.org/codes/documents/king3.pdf (accessed 15 January 2014).
- Financial Reporting Council (FRC). 2012, *The UK corporate governance code*, European Corporate Governance Institute (ECGI), http://www.ecgi.org/codes/documents/cg_code_uk_sep2012_en.pdf (accessed 15 January 2014).
- Ministry of Corporate Affairs, Government of India. 2009, *Corporate governance voluntary guidelines for India*, European Corporate Governance Institute (ECGI), http://www.ecgi.org/codes/documents/cg_voluntary_guidelines_2009_india_24dec2009_en.pdf (accessed 16 January 2014).

**Task Questions**

1. Identify the key words and phrases in the definitions and statements provided above (Canada, United Kingdom and India). What commonalities and differences exist between the definitions?
2. Then compare and contrast the three perspectives on corporate governance — South Africa, United Kingdom and India.
3. Carry out your own research on the two perspectives on corporate governance: 'comply or else' and 'comply or explain'. Which approach does your home country adopt? Discuss the possible reasons for your home country's approach.

Thompson (2007:3) states that good governance should aim to ensure that business is conducted and controlled in an ethical manner. Corporate governance involves developing management systems and effective controls, which include risk management, internal and external auditors, a company secretary, directors and management that are (1) responsible and (2) accountable to their stakeholders.

Although the emphasis on 'all stakeholders' is hotly debated, Goergen (2012:4) points out that shareholders and investors carry the most risk — they stand to lose the most if the organisation runs into trouble. On the contrary, the organisation's other stakeholders, such as its employees, suppliers and customers, can more easily walk away from the organisation without losing their investments.



"The providers of finance, and in particular shareholders, are the **residual risk bearers** or the **residual risk claimants** to the firm's assets. This means, if the organisation gets into financial distress, the claims of all the stakeholders other than the shareholders will be met first before the claims of the latter can be met."

"Typically, when the organisation is in financial distress, the organisation's assets are insufficient to meet all of the claims it is facing and the shareholders will lose their initial investment."

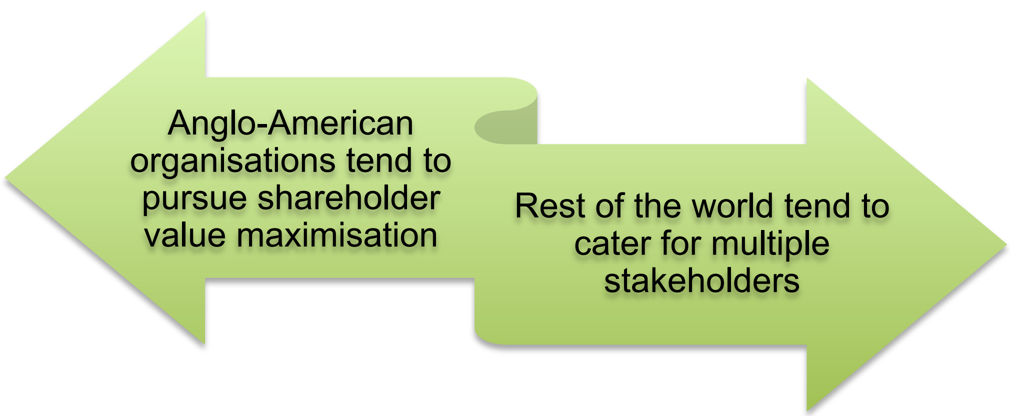
(Goergen, 2012:4)

Consider the following excerpt from Goergen (2012:5):

> "In a questionnaire survey sent to managers of German, Japanese, UK and US companies the question was asked as to whose company it is. While 89% of both UK and US managers state that the company belongs to the shareholders, only a minority of French, German and Japanese managers said so. 97% of Japanese managers believe that the company belongs to the stakeholders rather than the shareholders."

These two competing perspectives are shown in **Figure 1** below.

**FIGURE 1: SHAREHOLDER-CENTRIC VERSUS STAKEHOLDER-CENTRIC**




(Goergen, 2012:5)

Whilst this difference in focus (shareholder-centric versus stakeholder-centric) appears to be mutually exclusive, Goergen (2012:5–6) does argue that the two camps have moved closer to each other, citing that the UK's recent review of company law now states that directors should also recognise that companies need to foster relationships with their employees, customers and suppliers, and that they need to consider their impact on the communities and respective environments.

**Task Questions**

1. What evidence can you provide that demonstrates that the 'principle of shareholder primacy' is still intact in the USA and UK?
2. Is there any evidence to suggest that continental Europe has moved closer to a shareholder-centric system of corporate governance? Or, that the USA and UK have moved closer to a stakeholder-centric system?
3. What evidence is there that large organisations behave socially responsible? And, how might this evidence move these organisations toward a more stakeholder-centric model of corporate governance?

To conclude our broad definitions of corporate governance, consider the following definition, provided by Goergen (2012:6) — which, he argues, is less politically charged:

> Corporate governance deals with conflicts of interest between:
>
> - The providers of finance and the managers
> - The shareholders and the stakeholders, and
> - The different types of shareholders (mainly the large shareholder and the minority shareholder)
>
> And the prevention or mitigation of these conflicts of interests.
>
> (Goergen, 2012:6)

The advantage of this definition is that it can be applied to a variety of corporate governance systems — it does not assume that problems of corporate governance rest in any one domain and focuses attention on where the **conflicts of interest** might lie.

According to Thompson (2007:3), four main activities are associated with corporate governance. These are outlined in **Table 1.**

**TABLE 1: ACTIVITIES ASSOCIATED WITH CORPORATE GOVERNANCE**

| | |
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| **Direction** | The board of directors appointed by shareholders is responsible for corporate governance. They not only formulate strategic direction but also direct the affairs of the organisation. |
| **Executive action** | Executives are responsible for the administration of an organisation. |
| **Supervision** | Requiring monitoring and overseeing management performance. |
| **Accountability** | Whereby the organisation recognises its responsibilities to all stakeholders of an organisation. |

Clearly, there are core tasks associated with corporate governance — direction, executive action, supervision and accountability, and these are carried out within the scope of the law and principles and practices.

Broadly, it could be argued that:

Well-defined corporate governance provides structure that benefits stakeholders by ensuring the organisation adheres to accepted ethical standards as well as formal legislation. It is based on sound business ethics and ensures proper compliance with legal and regulatory requirements whilst also taking into account the expectations of all key stakeholders including shareholders.

Effective corporate governance requires a clear understanding of the roles of the board and senior management and their relationships with other organisational structures. This relationship should be characterised by fairness, good citizenship and compliance.

## Corporate Governance Terminology and Theory

We have alluded to 'Agency Theory' in our opening discussions.  This section highlights key theoretical concepts that inform more extensive discussion around corporate governance issues. For ease of reference, and to facilitate discussion, we begin by summarising some of the most important terminology.

**TABLE 2: CORPORATE GOVERNANCE TERMINOLOGY**

| Term | Explanation |
|---|---|
| **Principal-agent theory** | A supposition that explains the relationship between principals (such as shareholders) and agents of the principals (such as company executives). The theory is concerned with resolving problems in this relationship:<br>• The problems that arise when the desires or goals of the principal and agent are in conflict and the principal is unable to verify (because it is difficult or expensive to do so) what the agent is actually doing, and<br>• The problems that arise when the principal and agent have different attitudes towards risk (because of the different risk tolerances the principal and agent may each be inclined to take different actions).<br>(Investopedia, 2013a) |
| **Moral hazard** | The contract between shareholders and the executives/ directors (agents) leaves these agents with much discretion because they have the knowledge and ability to run the organisation. Agents, for example, can act in their own interests instead of in shareholders' interests by authorising excessive bonuses. The moral hazard problem causes shareholders to seek some other assurance that agents are following through on their commitment — that is a robust corporate governance framework.<br>(Olin, 2005) |
| **Disclosure requirements** | Directors must report about the condition of their organisations to the shareholders (i.e. through quarterly and annual reports). These reports provide the 'true' and 'fair' financial health of the organisation at that time as well as over a period of time (audited financial statements are a financial mechanism for corporate governance). Through disclosure requirements, shareholders should be able to check whether the agents of the organisation are working in their best interests.<br>(Olin, 2005) |