*Unit 4*

BBM 208/05

Business Ethics

# The Responsible Organisation

wawasan open UNIVERSITY

the people's university

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# Unit Overview

In this unit, we will discuss three specific areas, namely — corporate social responsibility, corporate governance and the code of ethics.

Corporate social responsibility is a company's sense of responsibility towards the community and environment (both ecological and social) in which it operates. Companies express this citizenship (1) through their waste and pollution reduction processes; (2) by contributing educational and social programmes; and (3) by earning adequate returns on the employed resources. The section starts with a discussion on the principal ways business are organised, followed by the three theories of corporate social responsibility. The section will end with arguments in favour and against corporate social responsibility.

Corporate governance is a term that refers broadly to the rules, processes or laws by which businesses are operated, regulated and controlled. The term can refer to internal factors defined by the officers, stockholders or constitution of a corporation as well as to external forces such as consumer groups, clients and government regulations. In this section, we will define the concept of corporate governance and discuss the theoretical approaches to corporate governance. We will end the section with a discussion on the roles and responsibilities of the Board of Directors from the corporate governance perspective.

A code of ethics is a set of rules outlining the responsibilities of or proper practices for an individual, party or organisation. We will discuss the roles of the code and its difficulties. We will end the section with a discussion on the objections and the side effects of the code of ethics.

# Unit Objectives

By the end of Unit 4, you should be able to:

1. Discuss the principal ways businesses are organised.
2. Examine the three theories of corporate social responsibility.
3. Elaborate the arguments in favour of corporate social responsibility.
4. Elaborate the arguments in favour that the objective of corporation is making profits.
5. Define the concept and the theoretical approaches to corporate governance.

6. Discuss the roles and responsibilities of the Board of Directors.

7. Define the code of ethics, its roles and objections.

# 4.1 Corporate Social Responsibility

## Objectives

By the end of this section, you should be able to:

1. Distinguish and define the principal ways of organising a business.
2. Consider liability and ethical responsibility as they relate to different forms of businesses.
3. Describe the organisational structure of a corporation.
4. Define and discuss the three main theories of corporate social responsibility.
5. Define and elaborate the major arguments in favour of corporations having social and environmental responsibilities.
6. Define and elaborate the major arguments in favour of the corporate purpose as limited to increasing profits.
7. Define and elaborate major arguments against corporations accepting broad social and environmental responsibilities.

## Introduction

Over the decades, the concept of Corporate Social Responsibility (CSR) has continued to grow in importance and significance. The idea that business enterprises have some responsibilities to society beyond that of making profits for shareholders has been around for centuries. It was largely a post World War II phenomenon and did not surge in importance until the 1960s and beyond. Today, one cannot pick up a newspaper, magazine or a journal without encountering some discussion of the issue. CSR refers to operating a business in a manner that accounts for the social and environmental impact created by the business. CSR means a commitment to developing policies that integrate responsible practices into daily business operations and to report on progress made toward implementing these practices.

## What kind of business organisations are there?

Consider the following story:

**Paramount Pictures**

Movies from Paramount Pictures begin with an image of a mountain flashed onto the screen. That mountain, reputedly, was quick-sketched on a notepad by the company's founder W. W. Hodkinson. Hodkinson started the movie business

in the early 1900s when he opened a theater in Ogden, Utah. He shuffled films faster than his competitors (the town's two other movie houses), and so came to dominate the local market. Soon he expanded to the big city of Salt Lake, then Los Angeles and onward.

Looking to keep his enterprise growing, Hodkinson founded a company called Paramount to provide up-front money to cash-strapped movie producers. In exchange, he got exclusive rights to screen their work in theaters. Grateful for the help, the trust and above all for the cash, struggling moviemakers including Adolph Zukor, Samuel Goldfish (later Goldwyn) and Cecil B. DeMille signed on to the project in five-year deals. By 1915, they were all wealthier.

Now that they no longer needed his up-front money, Zukor and the rest started trying to squirm out of their deal. Having initially taken the risk to launch their careers, Hodkinson refused to let them go. So Zukor and friends hatched a plan. Pretending to have been faced down by Hodkinson, they not only embraced the deal they had already inked, but they also extended it for twenty-five more years in exchange for a lump sum. They took that money, opened a line of credit and began secretly buying Paramount stock. When they accumulated enough, they took it over and in what would be a good premise for a revenge movie, they kicked Hodkinson out of his own company.

## Types of businesses

One lesson of Hodkinson's story is that the way a business is organised is critically important. He left Paramount open to a financial sneak attack by not keeping the whole company in his name as a sole proprietorship. When he let shares go out — when he allowed others to buy part ownership in his enterprise — he was setting himself up for what happened. Of course it is also true that he probably would not have had the money needed to get the enterprise going in the first place had he not gotten a capital injection from selling off pieces of ownership.

Every form of business organisation comes with advantages and disadvantages, and the specific kinds of organisation that may be formed are numerous and change from state to state. There are, however, a number of basic types:

1. Sole-proprietorship.
2. Partnership.
3. Limited Liability Partnership (LLP).
4. Non-profit organisation.
5. Corporation.

## Sole-proprietorship

A sole-proprietorship is the easiest kind of business to start. According to Suruhanjaya Syarikat Malaysia, SSM (Companies Commission of Malaysia), a sole-proprietorship is business wholly-owned by a single individual using his/her personal name as per his/her identity card or trade name. A sole proprietorship is the easiest kind of business to start. Registration of the business can be completed within 30 business days from the commencement of the business. Registration can be done at any SSM counter or through e-Lodgement services. The individual needs to complete the Business Registration Form (Form A) and refer to the Guidelines for New Business Registration.

### Web Reference

Please refer to the following webpage http://www.ssm.com.my/en/sole/starting-a-sole-proprietorship-partnership for additional details related to starting a sole-proprietorship organisation.

A business may be registered using a personal name or a trade name. Below are some details pertaining to sole-proprietorship:

1. Personal Name — Business name using personal name as stated in the identity card is not required to apply for business name approval. Fees: RM30 per year.

2. Trade Name — Complete business name approval form (Form PNA.42). Refer to Guidelines for Business Name Application. Fees: RM60 per year

3. Business name is approved according to Rule 15 under the Rules of Business Registration 1957 and a business registration can be made for a period of one (1) year and not more than five (5) years.

4. Business certificate can be obtained within an hour after payment. The validity of the certificate will be within the Registration of Business Act 1956.

Sole-proprietorships have the advantage of belonging to their owner i.e., the owner can do whatever he/she wants with his/her company without fear of being taken over by someone else. If you are Jan Jones and you sign contracts to pay $2,500 to rent a vacant warehouse along with the rights to show Paramount's Mommie Dearest, and you receive $3,000 from ticket buyers.

The main disadvantage of a sole-proprietorship is that the company really is an extension of you, and you are on the hook for whatever it does. So if you screen your movie and no one shows up, you cannot just call the whole thing a bad idea,

declare bankruptcy and walk away. Your lenders can sue you personally for the $2,500 you agreed to pay as JJ's Midnight Movie House. Worse, if people do show up, but someone smokes in the theater, which starts a fire and causes injuries, those injured can sue you personally and maybe take everything you own. The fact that Jan Jones has to take full responsibility for what her company does is called unlimited liability. That liability, finally, is legal, but it is also clear that there is an ethical dimension to the responsibility. While few assert that it is morally wrong to fail in business, there is a reasonable objection to be made when those who fail try to avoid paying the cost. The disadvantage of sole-proprietorship is that the company will cease operation once the owner dies.

## Partnership

A partnership resembles a sole proprietorship. The main difference, obviously, is that there is more than one owner: maybe there are two partners with 50 percent each, or one with 50 percent and then a group of smaller shareholders each owning 10 percent of the enterprise. The bookkeeping is pretty straightforward since profits are allotted in accordance with how great a share each partner owns. All partnerships must have, finally, at least one general partner who faces unlimited liability for the company's actions. On the ethical front, responsibility starts getting murky as you move to multiple owners. If the theater burns down, and one individual partner had been assigned (and failed) the task of making sure there were a few fire extinguishers around, does that one partner bear the entire ethical burden of the injuries? Is it doled out in accordance with the percentage owned? What if one of the owners just kicked some money in as a favour to a friend, and was not involved in the actual operation, does she bear any responsibility for what happened?

The process to register a partnership is the same as sole proprietorship.

## Limited liability partnership (LLP)

Limited Liability Partnership (LLP) is an alternative business vehicle regulated under the Limited Liability Partnerships Act 2012 which combines the characteristics of a company and a conventional partnership.

The LLP business structure is designed for all lawful business purposes with a view to make profit. LLP may also be formed by professionals such as Lawyers, Chartered Accountants and Company Secretaries for the purpose of carrying on their professional practice. The LLP concept will also support start ups, small and medium enterprises (SMEs) to grow their businesses without having to worry too much on their personal liabilities, personal assets and strict compliance requirements. Amongst others, LLP is featured with the protection of limited liability to its partners similar to the limited liability enjoyed by shareholders of a company coupled with flexibility of internal business regulation through partnership arrangement similar to a conventional partnership.

Any debts and obligations of the LLP will be borne by the assets of the LLP and not that of its partners'. An LLP has the legal status of a body corporate which is capable of suing and being sued in its own name, holding assets and doing such other acts and things in its name as bodies corporate may lawfully do and suffer.

LLP also offers flexibility in terms of its formation, maintenance and termination while simultaneously has the necessary dynamics and appeal to be able to compete domestically and internationally. With the introduction of LLP, entrepreneurs will have more options to choose the most preferred form of business vehicle.

**Web Reference**

Please refer to the following webpage: http://www.ssm.com.my/en/LLP-AboutLLP and a list of Limited Liability Partnership Forms: http://www.ssm.com.my/en/LLP-FormEn for more details regarding limited liability partnerships.

The main reason people form an LLP — is that the enterprise's legal status provides some protection against liability lawsuits. If you, Jan Jones, and a few others form an LLP and the theater burns and people get injured, you may get out without losing all you have. Creditors and lawyers for the injured will be able to sue the company and probably take any money left in the till, but they will have a harder time trying to take your personal car or the house you live in. Specific rules, it is important to note, vary depending on the business and the location, but both options are typically limited to a certain number of participants.

On the responsibility front, this is the pressing ethical question: If the theater burns down for an LLP, the owners will likely enjoy some legal protection. Does that protection, however, extend to the ethics? Is there any difference in terms of *moral responsibility* between a partnership operating a burning theater and an LLP?

| | Sole Proprietorship / Partnership | Sdn Bhd Company |
|---|---|---|
| Liability | Unlimited.<br>Your personal wealth may be affected & exposed to risks | Limited.<br>Your personal wealth will be protected |
| When can start busines | 8 – 10 days | 24 hours (shelf company)<br>10 days (new company) |
| Start up costs | RM400+ | RM1,460 |
| Annual maintenance | RM200++ | RM2,200++ |
| Ability to obtain loan | Not easy.<br>Depends on owner's personal capacity & wealth | Easier.<br>Depends on company cash flow, strategy and business prospects |
| Tax risk exposure | High.<br>Due to low level of financial & compliance requirements | Low.<br>Better managed and regulated |
| Tax planning opportunities | Limited.<br>Tax on personal. | Better tax planning as company is a separate legal entity. Tax on corporate. |

**Table 4.1** Comparison between Sdn Bhd company and partnership/sole-proprietor
Source: http://ssm-syarikat.com/difference-rob.html

## Non-profit corporations

Non-profit corporations exist in a class by themselves. Usually formed to serve a charitable or civic cause, they do not have to pay taxes since they do not make profits: they spend all their income promoting the cause they are set up to serve. The operators of non-profits often enjoy complete protection from liability claims. What about the ethics? If a non-profit screens *Mommie Dearest* to raise money for the cause of orphans, and the theater burns, does the fact that the entire endeavour was arranged for the public good provide moral protection from guilt when people get hurt?

## Corporations

Corporations step away from easier-to-form partnerships by providing protection to owners against liability claims. In the case of corporations, that protection is significant. In many cases, the protection is *total*: completely insulated from liability, shareholders can lose their investment if the company does something it should not and gets sued, but their personal possessions are completely safe. This is the case, for example, with the mega movie chain Regal Cinemas. The price

of one share of that company today was $13.77. If you buy that, then no matter what the company does tomorrow, the most you could possibly lose is a little under $15. No one likes to lose $15, but still, there is a very large freedom from responsibility here. If Regal tries to save some money (and therefore boost its share price and your profit) by intentionally not charging their fire extinguishers, and on the day a blockbuster gets released ten theaters in various states burn with accompanying human suffering and a major number of deaths, the company may go bankrupt under a flood of lawsuits and justifiable public outrage. But you, one of the owners, would be out three $5 bills.

Corporations play a very large role in business ethics for two reasons. First, their independence from their specific owners opens questions about who — if anyone — should take moral responsibility for what the corporation does. Second, because corporations today have grown so large and powerful, because they touch all our lives in so many ways so often, the ethical questions they raise become hard to avoid. Both these dimensions of the modern corporation, the ethical ambiguity and the potentially huge size, relate to the history of the institution.

In the Malaysian context, the two types of companies that can be incorporated under the Companies Act 1965 (CA 65) are:

1. A company limited by shares

2. An unlimited company

## Company limited by shares

A company having a share capital may be incorporated as a private company (identified through the words 'Sendirian Berhad' or 'Sdn. Bhd.' appearing together with the company's name) or public company 'Berhad' or 'Bhd' appearing together with the company's name).

The requirements to form a company are:

1. A minimum of two subscribers to the shares of the company (Section 14 CA);

2. A minimum of two directors (Section 122); and

3. A company secretary who can be either:

    a. An individual who is a member of a professional body prescribes by the Minister of Domestic Trade Cooperative and Consumerism; or

    b. An individual licensed by the Companies Commission of Malaysia (SSM).

Both the director and company secretary shall have their principal or only place or residence within Malaysia.

*Incorporation procedures*

1. **Application of name search**

   A name search must be conducted to determine whether the proposed name of the company is available. Please refer to Government Gazette No. 716 dated 30 January 1997, Gazette (Amendment) dated 11 October 2001, Guidelines For Naming A Company and Guidelines For Application Of A Company Name. The steps involved are:

   a. Completion and submission of Form 13A CA (Request For Availability Of Name) to SSM; and

   b. Payment of a RM30.00 fee for each name applied.

   Where the proposed company's name is approved by SSM, it shall be reserved for three months from the date of approval.

2. **Lodgement of incorporation documents**

   Incorporation Documents (as further explained in Part B below) must be submitted to SSM within 3 months from the date of approval of the company's name by SSM, failure of which a fresh application for a name search must be done. (Steps (a) and (b) above have to be repeated).

*Incorporation documents to be lodged with SSM*

1. **Memorandum and Article of Association**

   An original copy of the Memorandum and Article of Association shall each be stamped at RM100.00. Stamps are affixed at the Inland Revenue Board's stamp office.

   a. The first directors and secretaries shall be named in the Memorandum and Article of Association.

   b. The subscribers to the company's shares shall sign the Memorandum and Articles of Association in front of a witness.

   c. Table A of the Fourth Schedule in the CA can be adopted as the Article of Association of the company (Section 30 CA).

   *Note: For incorporation of a private company, the articles of association shall contain the following stipulations.

a. Restriction on the right to transfer the company's shares;

b. Limitation on the number of members to not exceed fifty;

c. Prohibition to any invitation to the public to subscribe the shares/debentures of the company; and

d. Prohibition on public invitation to deposit money with the company.

2. **Form 48A** (Statuary Declaration by a director or promoter before appointment) The director or promoter declares under oath that:

   a. He/She is not a bankrupt; and

   b. He/She has not been convicted and imprisoned for any prescribed offences.

3. **Form 6** (Declaration of compliance)

   This declaration states that all the requirements of the CA have been complied with. It must be signed by the company secretary who handles the registration and is named in the Memorandum and Articles of Association.

4. **Additional documents**:

   a. Original copy of Form 13A.

   b. A copy of the letter from SSM approving the name of the company.

   c. A copy of the identity card of each director and company secretary.

*Registration fees*

Each application for the incorporation of a company shall be accompanied with payment as per the schedule following:

| AUTHORISED SHARE CAPITAL (RM) | FEES (RM) |
|---|---|
| Up to 400,000 | 1,000 |
| 400,001 – 500,000 | 3,000 |
| 500,001 – 1 million | 5,000 |
| 1,000,001 – 5 million | 8,000 |
| 5,000,001 – 10 million | 10,000 |
| 10,000,001 – 25 million | 20,000 |
| 25,000,001 – 50 million | 40,000 |
| 50,000,001 – 100 million | 50,000 |
| 100,000,001 and above | 70,000 |

### *Certificate of incorporation*

A certificate of incorporation will be issued by SSM upon compliance with the incorporation procedures and submission of the duly completed incorporation documents.

## Unlimited company

The procedures and incorporation documents for the incorporation of an unlimited company is the same as company limited by shares. The only difference is that for an unlimited company, the liability of its members must be stated in the Memorandum of Association as unlimited.

### *A brief history and description of the corporation*

Exxon Mobil's market value is around $450 billion. Just to compare, the GDP of Portugal — the total value of all goods and services produced in the country each year — is about $250 billion (when converted to US dollars). Walmart's revenues are climbing above $375 billion, which is a full third of the total revenues (in the form of taxes) collected by the US federal government from individuals. If Walmart were a sovereign nation, it would be China's fourth largest export market. Less abstractly, the size and penetration of the Ford Motor Company can be felt just by going out on the street and watching their products pass by. And if you go to a movie from Paramount, or laugh for a while with the Comedy Channel, or check out music videos on MTV, you are patronising the behemoth called Viacom.

All these businesses, along with the rest of the corporations on the *Fortune* 500 list and then the many that did not make the top tier, change our lives most every day. If you outfitted your dorm room or apartment at Walmart, it was a decision made by an executive buyer that determined the choices you would have. If you are thinking about voting this year, Jon Stewart at Comedy Central is doing all he can to guide the way you decide which lever to pull. If you go to see a concert next weekend, an MTV executive may have been the one who originally pulled that group out of obscurity. Publicly held corporations, all this means, are not just places where we go to work, or manufacturers that supply our necessities: they set the parameters and directions of our lives.

The first corporations extended directly from governments. In 1600, the English monarchy designated the British East India Company to manage international trade between the homeland and the Indian subcontinent. Shareholders did extremely well. By the 1800s, private enterprise was breaking away from tight governmental association; the corporation as we know it today began taking shape when individuals started claiming a right to freely associate for their economic benefit without direct governmental oversight and license.

Modern corporations are formed by a group of people who fill out the papers and register the name. Once it is created, however, the business exists as a *legally distinct entity*. In the eyes of the law, it is:

1. Perpetual — it can survive even after its founders have passed away.

2. Responsible — just like a person — in the narrow sense in that it holds specific legal obligations and rights.

In 1819, the US Supreme Court defined a corporation as "an artificial being, invisible, intangible and existing only in the contemplation of the law" *Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518 (1819)*. This legal independence clears the way for owners (shareholders) to escape liability claims made against the corporation. Because the business stands on its own, because it is a "being," all claims must be made against it, not the shareholders standing behind.

Corporations are structured in diverse ways, but the basic governing form starts with the shareholders electing a board of directors. Walmart, for example, is governed by a fifteen-member board, which is elected each year. The board holds two main responsibilities. One is oversight; it keeps track of what is going on and reports back to shareholders. The other responsibility is operational. The board selects individuals who will run the company on a day-to-day basis. Frequently, a chief executive officer (CEO) leads this team and is ultimately responsible for making sure Walmart is buying from suppliers at the lowest possible price, getting goods into the stores before stock runs out, and convincing customers to return and do more buying.

If the CEO and management team is good, there is a decent chance the company will be successful and grow. Good leadership, however, cannot alone explain the mega dimensions of today's larger corporations. One critical element of the corporate structure that contributes to the size is the owner-as-shareholder model. The model allows businesses to collect large amounts of cash quickly. Simply by printing up and selling more shares, a corporation raises potentially huge sums. That capital can be reinvested in the business — maybe to build new Walmart stores in growing suburbs — and the corporation's value goes up. It is true that the original shareholders now own less of the company on a percentage basis (because there are more owners), but their shares are worth more because the company is worth more, so they are unlikely to complain. As long as that virtuous cycle continues, well-run corporations can grow very quickly.

While all that growth is going on, the actual owners — shareholders — can be at home sitting in front of the TV. Many shareholders, actually, have almost no idea of what is happening inside the company they partially own. With respect to business ethics, this adds another level of complexity to the question about who, if anyone, should be held *morally* responsible for what the corporation does. If you just go out in the street and ask a passerby, "Who do you think bears moral responsibility for what a company does?" the answer you will probably get is the owners. But in the case of corporations, they are protected *legally* by a liability firewall, and now they are also protected *structurally* by the fact that they — along with the multitude of other owners scattered all over the country and even the globe — are not necessarily involved in making the company's operational decisions. These two factors combined have thrust this question to the forefront of questions about ethics in the economic world: can these artificial beings called corporations themselves have moral responsibilities to go along with their legal responsibility to operate within the law?

**Activity 4.1**

1. What are the main ways of organising a business?

2. Why might someone choose to organise as an LLP instead of a sole proprietorship?

3. In legal terms, what is the relation between a corporation and those individuals who found the corporation?

4. In what ways does the structure of a corporation protect its owners from absorbing ethical responsibility for the company's actions?

## Three Theories of Corporate Social Responsibility

### Corporations as responsible

*A Civil Action* was originally a novel, but more people have seen the movie, which was distributed by W. W. Hodkinson's old company, Paramount. One of the memorable scenes is John Travolta playing a hotshot lawyer speeding up a rural highway to Woburn, Massachusetts. He gets pulled over and ticketed. Then he continues on his way to investigate whether there is any money to be made launching a lawsuit against a company that allowed toxic industrial waste to escape into the town's aquifer. The polluted water, Travolta suspects, eventually surfaced as birth defects. After checking things out, he races his Porsche back to Boston at the same speed. Same result. *A Civil Action*, a film directed by Steven Zaillian, New York: Scott Rudin, 1998.

One of the movie's messages is that many corporations are like greedy lawyers — they have little sense of right and wrong, and their behaviour can only be modified by money. The lesson is that you cannot make Travolta slow down and drive safely by appealing to the right of others to use the road without being threatened by speeding Porsches, or by pleading with him to respect general social well-being that is served when everyone travels at about the same speed. If you want him to slow down, there is only one effective strategy: raise the traffic ticket fine. Make the money hurt. Analogously for companies, if you want them to stop polluting, hit them with harder penalties when they are caught.

What if that is not the only way for corporations to exist in the world, though? What if people who directed businesses began understanding their enterprise not only in financial terms (as profits and losses) but also in ethical ones? What if companies became, in a certain moral sense, like people, members of society bound by the same kinds of duties and responsibilities that you and I wrestle with every day? When companies are seen that way, a conception of *corporate social responsibility* comes forward.

### Three approaches to corporate responsibility

According to the traditional view of the corporation, it exists primarily to make profits. From this money-centered perspective, insofar as business ethics are important, they apply to moral dilemmas arising as the struggle for profit proceeds. These dilemmas include: "What obligations do organisations have to ensure that individuals seeking employment or promotion are treated fairly?" "How should conflicts of interest be handled?" and "What kind of advertising strategy should be pursued?" Most of this unit has been dedicated to these and similar questions.

While these dilemmas continue to be important throughout the economic world, when businesses are conceived as holding a wide range of economic and civic responsibilities as part of their daily operation, the field of business ethics expands correspondingly. Now there are large sets of issues that need to be confronted and managed outside of and independent of the struggle for money. Broadly, there are three theoretical approaches to these new responsibilities:

1. Corporate social responsibility (CSR).

2. The triple bottom line.

3. Stakeholder theory.

## Corporate Social Responsibility (CSR)

The title corporate social responsibility has two meanings. First, it is a general name for any theory of the corporation that emphasises both the responsibility to make money and the responsibility to interact ethically with the surrounding community. Second, corporate social responsibility is also a specific conception of that responsibility to profit while playing a role in broader questions of community welfare.

As a specific theory of the way corporations interact with the surrounding community and larger world, corporate social responsibility (CSR) is composed of four obligations:

1. The **economic responsibility** to *make money*. Required by simple economics, this obligation is the business version of the human survival instinct. Companies that do not make profits are — in a modern market economy — doomed to perish. Of course there are special cases. Non-profit organisations make money (from their own activities as well as through donations and grants), but pour it back into their work. Also, public/private hybrids can operate without turning a profit. In some cities, trash collection is handled by this kind of organisation, one that keeps the streets clean without (at least theoretically) making anyone rich. For the vast majority of operations, however, there have to be profits. Without them, there is no business and no business ethics.

2. The **legal responsibility** *to adhere to rules and regulations. Like the previous, this responsibility is not controversial.* What proponents of CSR argue, however, is that this obligation must be understood as a proactive duty. That is, laws are not boundaries that enterprises skirt and cross over if the penalty is low; instead, responsible organisations accept the rules as a social good and make good faith efforts to obey not just the letter but also the spirit of the limits. In concrete terms, this is the difference between the driver who stays under the speed limit because he cannot afford a traffic ticket, and one who obeys because society as a whole is served when we all agree to respect the signs and stoplights and limits. Going back to John Travolta racing his Porsche up and down the rural highway, he sensed none of this respect. The same goes for the toxic company W. R. Grace Incorporated as it is portrayed in the movie: neither one obeys regulations and laws until the fines get so high they have got no choice. As against that model of behaviour, a CSR vision of business affirms that society's limits will be scrupulously obeyed, even if the fine is only one dollar.

3. The **ethical responsibility** *to do what is right even when not required by the letter or spirit of the law*. This is the theory's keystone obligation, and it depends on a coherent corporate culture that views the business itself as a citizen in society, with the kind of obligations that citizenship normally entails. When someone is racing their Porsche along a country road on a freezing winter's night and encounters another driver stopped on the roadside with a flat, there is a social obligation to do something, though not a legal one. The same logic can work in the corporate world. Many industrial plants produce, as an unavoidable part of their fabricating process, poisonous waste. In Woburn, Massachusetts, W. R. Grace did that as well as Beatrice Foods. The law governing toxic waste disposal was ambiguous, but even if the companies were not legally required to enclose their poisons in double-encased, leak-proof barrels, is not that the right thing to do so as to ensure that the contamination will be safely contained? True, it might not be the right thing to do in terms of pure profits, but from a perspective that values everyone's welfare as being valuable, the measure could be recommendable.

4. The **philanthropic responsibility** *to contribute to society's projects even when they are independent of the particular business*. A lawyer driving home from work may spot the local children gathered around a makeshift lemonade stand and sense an obligation to buy a drink to contribute to the neighbourhood project. Similarly, a law firm may volunteer access to their offices for an afternoon every year so some local schoolchildren may take a field trip to discover what lawyers do all day. An industrial chemical company may take the lead in rehabilitating an empty lot into a park. None of these acts arise as obligations extending from the day-to-day operations of the business involved. They are not like the responsibility a chemical firm has for safe disposal of its waste. Instead, these public acts of generosity represent a view that businesses, like everyone in the world, have some obligation to support the general welfare in ways determined by the needs of the surrounding community.

Taken in order from top to bottom, these four obligations are *decreasingly* pressing within the theory of corporate social responsibility. After satisfying the top responsibility, attention turns to the second and so on. At the extremes, the logic behind this ranking works easily. A law firm on the verge of going broke probably does not have the responsibility to open up for school visits, at least not if the tours interfere with the accumulation of billable hours and revenue. Obviously, if the firm *does* go broke and out of business, there will not be any school visits in any case, so faced with financial hardship, lawyers are clearly obligated to fulfill their economic obligations before philanthropic ones.

**Figure 4.1** The diminishing corporate social responsibility as corporation responsibility increased

More difficult questions arise when the economic responsibility conflicts with the legal one. For example, to remain profitable, an industrial plant may need to dispose of waste and toxins in barrels that barely meet legally required strengths. Assuming those legal limits are insufficiently strict to guarantee the barrels' seal, the spirit of the law may seem violated. The positive economic aspect of the decision to cut corners is the ability to stay in business. That means local workers will not lose their jobs, the familial stresses of unemployment will be avoided, suppliers will maintain their contracts, and consumers will still be served. The negative, however, is the possibility — and the reality at Woburn — that those toxins will escape their containers and leave a generation of workers' children poisoned.

Knowing what we do now about those Woburn children, there is no real conflict; anything would have been better than letting the toxins escape. If necessary, the company should have accepted bankruptcy before causing the social damage it did. At the time of the decision, however, there may have been less certainty about exactly what the risks and benefits were. Even among individuals promoting a strong sense of corporate responsibility for the surrounding community, there may have been no clear answer to the question about the proper course of action. Regardless, corporate social responsibility means every business holds four kinds of obligations and should respond to them in order: first the economic, then the legal, next the ethical, and finally the philanthropic.

## The triple bottom line

The triple bottom line is a form of corporate social responsibility dictating that corporate leaders tabulate bottom-line results not only in economic terms (costs versus revenue) but also in terms of company effects in the social realm, and with respect to the environment. There are two keys to this idea. First, the three columns of responsibility must be kept separate, with results reported independently for each. Second, in all three of these areas, the company should obtain sustainable results.

The notion of sustainability is very specific. At the intersection of ethics and economics, **sustainability** means *the long-term maintenance of balance*. As elaborated by theorists including John Elkington, here is how the balance is defined and achieved economically, socially and environmentally:

1. **Economic sustainability** *values long-term financial solidity over more volatile, short-term profits, no matter how high*. According to the triple-bottom-line model, large corporations have a responsibility to create business plans allowing stable and prolonged action. That bias in favour of duration should make companies hesitant about investing in things like dot-coms. While it is true that speculative ventures may lead to windfalls, they may also lead to collapse. Silicon Valley, California, for example, is full of small, start-up companies. A few will convert into the next Google, Apple, and Microsoft. What gets left out, however, of the newspaper reports hailing the accomplishments of a Steve Jobs or a Bill Gates are all those other people who never made it — all those who invested family savings in a project that ended up bankrupt. Sustainability as a virtue means valuing business plans that may not lead to quick riches but that also avoid calamitous losses.

   Moving this reasoning over to the case of W. R. Grace dumping toxins into the ground soil, there is a possible economic-sustainability argument against that kind of action. Corporations trying to get away with polluting the environment or other kinds of objectionable actions may, it is true, increase their bottom line in the short term. Money is saved on disposal costs. Looking further out, however, there is a risk that a later discovery of the action could lead to catastrophic economic consequences (like personal injury lawyers filing huge lawsuits). This possibility leads immediately to the conclusion that concern for corporate sustainability in financial terms argues against the dumping.

2. **Social sustainability** *values balance in people's lives and the way we live*. A world in which a few *Fortune 500* executives are hauling down millions a year, while millions of people elsewhere in the world are living on pennies a day cannot go on forever. As the imbalances grow, as the rich get richer and the poor get both poorer and more numerous, the chances that society itself will collapse in anger and revolution increase. The threat of governmental overthrow from below sounds remote — almost absurd — to Americans who are accustomed to a solid middle class and minimal resentment of the wealthy. In world history, however, such revolutions are quite common. That doesn't mean revolution is coming to our time's developed nations. It may indicate, however, that for a business to be stable over the long term, opportunities and subsequently wealth need to be spread out to cover as many people as possible.

   The fair trade movement fits this ethical imperative to shared opportunity and wealth. Developed and refined as an idea in Europe in the 1960s, organisations promoting fair trade ask businesses — especially large producers

in the richest countries — to guarantee that suppliers in impoverished nations receive reasonable payment for their goods and services even when the raw economic laws of supply and demand do not require it. An array of ethical arguments may be arranged to support fair trade, but on the front of sustainability, the lead argument is that peace and order in the world depend on the world's resources being divided up in ways that limit envy, resentment, and anger.

Social sustainability does not end with dollars; it also requires *human respect*. All work, the logic of stability dictates, contains dignity, and no workers deserve to be treated like machines or as expendable tools on a production line. In today's capitalism, many see — and the perception is especially strong in Europe — a world in which dignity has been stripped away from a large number of trades and professions. They see minimum wage workers who will be fired as soon as the next economic downturn arrives. They see bosses hiring from temporary agencies, turning them over fast, not even bothering to learn their names. It is certainly possible that these kinds of attitudes, this contempt visible in so many workplaces where the McJob reigns, cannot continue. Just as people will not stand for pennies in wages while their bosses get millions, so too they ultimately will refuse to accept being treated as less dignified than the boss.

Finally, social sustainability requires that corporations as citizens in a specific community of people maintain a healthy relationship with those people. Fitting this obligation into the case of W. R. Grace in Woburn, it is immediately clear that any corporation spilling toxins that later appear as birth defects in area children is not going to be able to sustain anything with those living nearby. Any hope for cooperation in the name of mutual benefit will be drowned by justified hatred.

3. **Environmental sustainability** *begins from the affirmation that natural resources* — especially the oil fueling our engines, the clean air we breathe, and the water we drink — are limited. If those things deteriorate significantly, our children will not be able to enjoy the same quality of life most of us experience. Conservation of resources, therefore, becomes tremendously important, as does the development of new sources of energy that may substitute those we are currently using.

   Further, the case of an industrial chemical company pouring toxins into the ground that erupt years later with horrific consequences evidences this: not only are resources finite, but our earth is limited in its ability to naturally regenerate clean air and water from the smokestacks and runoff of our industries. There are, clearly, good faith debates that thoughtful people can have about *where* those limits are. For example, have we released greenhouse gases into the air so heavily that the earth's temperature is rising? No one knows for sure, but it is certain that *somewhere* there is a limit; at some point carbon-burning pollution will do to the planet what toxic runoff did in Woburn: make the place unlivable. Sustainability, finally, on this

environmental front means actions must be taken to facilitate our natural world's renewal. Recycling or cleaning up contamination that already exists is important here, as is limiting the pollution emitted from factories, cars, and consumer products in the first place. All these are actions that corporations must support, not because they are legally required to do so, but because the preservation of a livable planet is a direct obligation within the triple-bottom-line model of business responsibility.

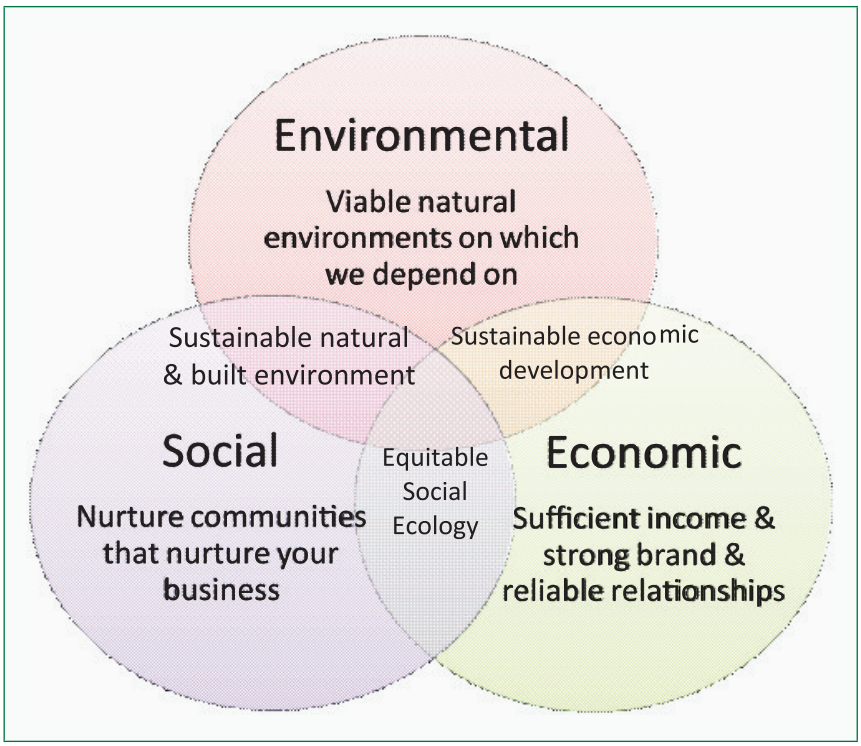


**Figure 4.2** The triple bottom line

Together, these three notions of sustainability — economic, social, and environmental — guide businesses toward actions fitted to the conception of the corporation as a participating citizen in the community and not just as a money machine.

One deep difference between corporate social responsibility and the triple bottom line is cultural. The first is more American, the second European. Americans, accustomed to economic progress, tend to be more comfortable with, and optimistic about, change. Collectively, Americans want business to transform the world, and ethical thinking is there (hopefully) to help the transformations maximise improvement across society. Europeans, accustomed to general economic decline with respect to the United States, view change much less favourably. Their inclination is to slow development down, and to keep things the same as far as possible. This outlook is naturally suited to sustainability as a guiding value.

It is important to note that while sustainability as a business goal puts the breaks on the economic world, and is very conservative in the (nonpolitical) sense that it favours the current situation over a changed one, that does not mean recommending a pure freeze. Sustainability is not the same as **Ludditism**, which is *a flat resistance to all technological change.*

The Luddites were a band of textile workers in Britain in the 1800s who saw (correctly) that mechanised looms would soon rob them not only of their livelihood but also of their way of life. To stop the change, they invaded a few factories and broke everything in sight. Their brute strategy succeeded very briefly and then failed totally. Today, Ludditism is the general opposition to new technologies in any industry on the grounds that they tear the existing social fabric: they force people to change in the workplace and then everyplace, whether they like it or not. There is an element of (perhaps justifiable) fear of the future in both Ludditism and the business ethics of sustainability, but there are differences between the two also. For example, sustainability concerns do not always stand against technological advances. Actually, innovation is favoured as long as advances are made in the name of maintaining the status quo. For example, advances in wind power generation may allow our society to continue using energy as we do, even as oil reserves dwindle, and with the further benefit of limiting air pollution.

## Stakeholder theory

Stakeholder theory, which has been described by Edward Freeman and others, is *the mirror image of corporate social responsibility. Instead of starting with a business and looking out into the world to see what ethical obligations are there, stakeholder theory starts in the world*. It lists and describes those individuals and groups who will be affected by (or affect) the company's actions and asks, "What are their legitimate claims on the business?" "What rights do they have with respect to the company's actions?" and "What kind of responsibilities and obligations can they justifiably impose on a particular business?" In a single sentence, stakeholder theory affirms that *those whose lives are touched by a corporation hold a right and obligation to participate in directing it.*

As a simple example, when a factory produces industrial waste, a CSR perspective attaches a responsibility directly to factory owners to dispose of the waste safely. By contrast, a stakeholder theorist begins with those living in the surrounding community who may find their environment poisoned, and begins to talk about business ethics by insisting that they have a right to clean air and water. Therefore, they are stakeholders in the company and their voices must contribute to corporate decisions. It is true that they may own no stock, but they have a moral claim to participate in the decision-making process. This is a very important point. At least in theoretical form, those affected by a company's actions actually become something like shareholders and owners. Because they are touched by a company's actions, they have a right to participate in managing it.

Who are the stakeholders surrounding companies? The answer depends on the particular business, but the list can be quite extensive. If the enterprise produces chemicals for industrial use and is located in a small Massachusetts town, the stakeholders include:

1. Company owners, whether a private individual or shareholders.
2. Company workers.
3. Customers and potential customers of the company.
4. Suppliers and potential suppliers to the company.
5. Everyone living in the town who may be affected by contamination from workplace operations.
6. Creditors whose money or loaned goods are mixed into the company's actions.
7. Government entities involved in regulation and taxation.
8. Local businesses that cater to company employees (restaurants where workers have lunch, grocery stores where employee families shop, and similar).
9. Other companies in the same line of work competing for market share.
10. Other companies that may find themselves subjected to new and potentially burdensome regulations because of contamination at that one Massachusetts plant.

The first five on the list — shareholders, workers, customers, suppliers, and community — may be cited as the five cardinal stakeholders.

The outer limits of stakeholding are blurry. In an abstract sense, it is probably true that everyone in the world counts as a stakeholder of any serious factory insofar as we all breathe the same air and because the global economy is so tightly linked that decisions taken in a boardroom in a small town on the East Coast can end up costing someone in India her job and the effects keep rippling out from there.

In practical terms, however, a strict stakeholder theory — one insistently bestowing the power to make ethical claims on anyone affected by a company's action — would be inoperable. There would be no end to simply figuring out whose rights needed to be accounted for. Realistically, the stakeholders surrounding a business should be defined as those tangibly affected by the company's action. There ought to be an unbroken line that you can follow from a corporate decision to an individual's life.

Once a discrete set of stakeholders surrounding an enterprise has been located, stakeholder ethics may begin. The purpose of the firm, underneath this theory, is to maximise profit on a collective bottom line, with profit defined not as money but as human welfare. The collective bottom line is the summed effect of a company's actions on all stakeholders. Company managers, that means, are primarily charged not with representing the interests of shareholders (the owners of the company) but with the more social task of coordinating the interests of all stakeholders, balancing them in the case of conflict and maximising the sum of benefits over the medium and long term. Corporate directors, in other words, spend part of the day just as directors always have: explaining to board members and shareholders how it is that the current plans will boost profits. They spend other parts of the day, however, talking with other stakeholders about their interests: they ask for input from local environmentalists about how pollution could be limited, they seek advice from consumers about how product safety could be improved and so on. At every turn, stakeholders are treated (to some extent) like shareholders, as people whose interests need to be served and whose voices carry real force.

In many cases transparency is an important value for those promoting stakeholder ethics. The reasoning is simple: if you are going to let every stakeholder actively participate in a corporation's decision making, then those stakeholders need to have a good idea about what is going on. In the case of W. R. Grace, for example, it is important to see that a stakeholder theory would not necessarily and immediately have acted to prohibit the dumping of toxins into the soil. Instead, the theory demands that all those who may be affected know what is being dumped, what the risks are to people and the environment, and what the costs are of taking the steps necessary to dispose of the chemical runoff more permanently and safely.

As already noted, we know now what W. R. Grace should have done under most every ethical theory. At the time, however, stakeholders fully informed of the situation may have been less sure because it was not so clear that the runoff would cause so many problems (or any problems at all). Given that, owners may have favoured dumping because that increases profits. Next, what about workers in town? It is important to keep in mind that the safe removal of the waste may have lowered company profits and potentially caused some layoffs or delayed wage hikes. As stakeholders, they may have been willing to agree to the dumping too. The same goes for community politicians who perhaps would see increased tax revenue as a positive effect of high corporate profits.

What is certain is that stakeholder theory obligates corporate directors to appeal to all sides and balance everyone's interests and welfare in the name of maximising benefits across the spectrum of those whose lives are touched by the business.

## Conclusion

Traditionally, the directors of companies have had an extremely difficult but very narrowly defined responsibility: guide the enterprise toward money. The best companies have been those generating the highest sales, gaining the most customers, and clearing the largest profits. As for ethical questions, they have been

arranged around the basic obligation to represent the owners' central interest, which presumably is to profit from their investment. Consequently, the field of business ethics has mainly concerned conflicts and dilemmas erupting inside the company as people try to work together to win in the very competitive economic world. The idea of corporate social responsibility — along with the related ideas of the triple bottom line and stakeholder theory — opens a different kind of business ethics. Morality in the economic world is now about corporate directors sensing and responding to a broad range of obligations, ones extending through the town where the business is located and then out into surrounding communities and through society generally. In Woburn, Massachusetts, in the early 1980s, this conflict between two ways of running a business played out in the Hollywood depiction of the lawyer played by John Travolta. At the movie's beginning, right and wrong for a business got decided in dollars and without broader sensibility. Travolta's law firm existed to make money and operated by accepting only cases that promised big payouts. That was what brought Travolta to Woburn, the chance to sue deep-pocketed W. R. Grace for poisoning the land with toxic runoff and for destroying the lives of families living near the pools of contamination. Over the course of the movie, however, Travolta becomes attached to Woburn's cause and the social good of fighting for a clean environment. By the end, he is risking his firm's high profits — and, according to his law-firm partners, all common sense — to make sure that harmed people living in town get their good lives back, and to ensure that a Woburn-like toxic disaster will not happen again.
In terms of business ethics, it is not difficult to interpret Travolta's transformation from a businessman taking care of the bottom line, to one engaged by a broader vision of social responsibility. Each of the three discussed theories — corporate social responsibility, the triple bottom line, stakeholder theory — can be fit into the movie A Civil Action.

In terms of corporate social responsibility, Travolta came to believe that his job as the law firm's leader obligated him to satisfy his economic responsibility to make money for the firm by suing for financial damages while also acting legally. Further, his firm needed to satisfy the ethical responsibility to help others in Woburn get their good lives back. Here, there is a basic duty to help others in need when you have the capability. Finally, there was an element of philanthropy in Travolta's endeavour because his law firm pursued a case that served the greater good even though more profitable work opportunities were available.

In terms of the triple bottom line of economics, society, and the environment, Travolta came to believe that his job as the law firm's leader obligated him to take account of and do well in all three areas. It was no longer enough to win money; his business had a moral responsibility to win for society and to win for the environment also. The long-term goal was to ensure the economic sustainability of his firm, the sustainability of healthy family life in Woburn, and the sustainability of clean earth and air in that part of Massachusetts.

In terms of stakeholder ethics, Travolta came to believe that his job as the law firm's leader obligated him not only to work for the firm's owners (including himself) but also to take direction from those who would be affected by the firm's actions. That meant considering — trying to balance and to add up — the interests of his partners and all those who lived in Woburn.

Finally, because Travolta's story was also a Hollywood story, his transformation on the big screen was presented as the change from an aloof bad guy to a caring good guy. It is not clear, however, in the real world whether a corporate ethics based on social responsibility, the triple bottom line, or all stakeholders is actually recommendable. The debate between the two ways of thinking about business — the traditional, profit-centered view and the broader, socially responsible view — is hard-fought and intensified by good arguments on both sides.

**Activity 4.2**

1. For corporate advocates of the specific CSR theory, what are the responsibilities the corporation holds, and how are conflicts between those responsibilities managed?

2. What does sustainability mean within each of the three columns of the theory of the triple bottom line?

3. How does the fair trade movement fit together with the triple-bottom-line theory of corporate responsibility?

4. Who are the stakeholders in stakeholder ethics?

5. What basic elements do CSR, the triple bottom line, and stakeholder theory have in common?

## Should corporations have social responsibilities? The arguments in favour

### Why should corporations have social responsibilities?

Broadly, there are three kinds of arguments in favour of placing corporations, at least large and fully developed ones, within an ethical context of expansive social and environmental responsibilities:

1. Corporations are morally required to accept those responsibilities.

2. The existence of externalities attaches companies, in operational and economic terms, to those responsibilities.

3. Enlightened self-interest leads to voluntarily embracing those responsibilities.

## The moral requirement argument

The moral requirement that business goals go beyond the bottom line to include the people and world we all share is built on the following arguments:

1. *Corporations are already involved in the broad social world and the ethical dilemmas defining it.* For example, factories producing toxic waste are making a statement about the safety and well-being of those living nearby every time they dispose of the toxins. If they follow the cheapest — and least safe — route in order to maximise profits, they are not avoiding the entire question of social responsibility; they are saying with their actions that the well-being of townspeople does not matter too much. That is an ethical stance. It may be good or bad, it may be justifiable or not, but it is definitely ethics. Choosing, in other words, not to be involved in surrounding ethical issues is an ethical choice. Finally, because companies are inescapably linked to the ethical issues surrounding them, they are involved with some form of corporate social responsibility whether they like it or not.

2. *Corporations, at least well-established, successful, and powerful ones, can be involved in the effective resolution of broad social problems, and that ability implies an obligation.* Whether we are talking about a person or a business, the possession of wealth and power is also a duty to balance that privilege by helping those with fewer resources. Many accept the argument that individuals who are extraordinarily rich have an obligation to give some back by, say, creating an educational foundation or something similar. That is why people say, "To whom much is given, much is expected." Here, what is being argued is that the same obligation applies to companies.

3. *Corporations rely on much more than their owners and shareholders.* They need suppliers who provide materials, employees who labour, a town where the workplace may be located, consumers who buy, air to breathe, water to drink, and almost everything. Because a business relies on all that, the argument goes, it is automatically responsible — to some extent — for the welfare and protection of those things.

4. *Because businesses cause problems in the larger world, they are obligated to participate in the problems' resolution.* What kinds of problems are caused? Taking the example of an industrial chemical factory, toxic waste is produced. Even though it may be disposed of carefully, that does not erase the fact that barrels of poison are buried somewhere and a threat remains, no matter how small. Similarly, companies that fire workers create social tensions. The dismissal may have been necessary or fully justified, but that does not change the fact that problems are produced, and with them comes a responsibility to participate in alleviating the negative effects.

## Conclusion

Taken together, these arguments justify the vision of any particular enterprise as much more than an economic wellspring of money. Businesses become partners in a wide world of interconnected problems and shared obligations to deal with them.

## The externality argument

The second type of argument favouring corporate social responsibility revolves around externalities. These attach corporations to social responsibilities not morally but operationally. *An externality in the economic world is a cost of a good or service that is not accounted for in the price (when that price is established through basic laws of supply and demand).* For example, if a corporation's factory emits significant air pollution, and that results in a high incidence of upper respiratory infections in the nearby town, then a disproportionately high number of teachers and police officers (among others) are going to call into work sick throughout the year. Substitute teachers and replacement officers will need to be hired, and that cost will be borne by everyone in town when they receive a higher tax bill. The corporation owning the pollution-belching factory, that means, gets the full amount of money from the sale of its products but does not pay the full cost of producing them since the broader public is shouldering part of the pollution bill. This strikes many as unfair.

Another example might be a company underfunding its pension accounts. The business may eventually shut its doors, deliver final profits to shareholders, and leave retired workers without the monthly checks they had been counting on. Then the government may have to step in with food stamps, welfare payments, and similar to make up for the shortfall, and in the final tabulation, the general public ends up paying labor costs that should have been borne by shareholders.

*Externalities, it should be noted, are not always negative.* For example, the iPhone does a pretty good job of displaying traffic congestion in real time on its map. That ability costs money to develop, which Apple invested, and then they get cash back when an iPhone sells. Apple does not receive, however, anything from those drivers who do not purchase an iPhone but still benefit from it: those who get to where they're going a bit faster because everyone who does have an iPhone is navigating an alternate route. More, everyone benefits from cleaner air when traffic jams are diminished, but again, that part of the benefit, which should channel back to Apple to offset its research and production costs, ends up uncompensated.

Whether an externality is negative or positive — whether a company's bottom line rises or falls with it — a strong argument remains for broad corporate responsibility wherever an externality exists. Because these parts of corporate interaction with the world are not accounted for in dollars and cents, a broad ethical discussion must be introduced to determine what, if any, obligations or benefits arise.

## The enlightened self-interest argument

The third kind of argument in favour of corporations as seats of social responsibility grows from the notion of enlightened self-interest. Enlightened self-interest means businesses take on broad responsibilities because, on careful analysis, that public generosity also benefits the company. The benefits run along a number of lines:

1. *Corporations perceived as socially engaged may be rewarded with more and more satisfied customers.* TOMS shoes is an excellent example. For every pair of shoes they sell, they give a pair away to needy children. No one doubts that this is a noble action — one displaying corporate vision as going beyond the bottom line — but it is also quite lucrative. Many people buy from TOMS because of the antipoverty donations, and those customers feel good about their footwear knowing that a child somewhere is better off.

2. *Organisations positively engaged with society or the environment may find it easier to hire top-notch employees.* All workers seek job satisfaction, and given that you spend eight hours a day on the job, the ingredients of satisfaction go beyond salary level. Consequently, workers who select from multiple job offers may find themselves attracted to an enterprise that does some good in the world. This point can also be repeated negatively. Some organisations with more checkered reputations may find it difficult to hire good people even at a high salary because workers simply do not want to have their name associated with the operation. A curious example to fit in here is the Central Intelligence Agency. Some people will accept a job there at a salary lower than they would make in the private realm because it is the CIA, and others will not work there even if it is their best offer in terms of money because it is the CIA.

3. *Organisations taking the initiative in regulating themselves in the name of social betterment may hold off more stringent requirements that might otherwise be imposed by governmental authorities.* For example, a lab fabricating industrial chemicals may wrap their toxic waste in not only the legally required single, leak-proof barrel but a second as well, to positively ensure public safety. That proactive step is not only good for the environment, but it may help the bottom line if it effectively closes off a regulatory commission's discussion about requiring *triple* barrel protections.

Enlightened self-interest starts with the belief that there are many opportunities for corporations to do well (make money) in the world by doing good (being ethically responsible). From there, it is reasonable to assert that because those opportunities exist, corporations have no excuse for not seeking them out, and then profiting from them, while helping everyone else along the way.

One basic question about enlightened self-interest is, "Are corporations making money because they are doing good deeds, or are they doing good deeds because it makes them money?" In terms of pure consequences, this distinction may not be

significant. However, if the reality is that social good is being done only because it makes money, then some will object that corporate social responsibility is twisting into a clever trick employed to maximise profits by deceiving consumers about a business's intention. CSR becomes an example of cause egoism — that is, giving the false appearance of being concerned with the welfare of others in order to advance one's own interests.

**Activity 4.3**

1. In your own words, what are a few reasons a corporation may feel directly required to respond to broad social obligations?

2. What is an example of an externality? How could the existence of that externality be transformed into an argument in favour of corporate social responsibility?

## Should corporations have social responsibilities? The arguments against

### The only corporate responsibility is to increase profits

In 1970, just as the idea of corporate social responsibility was gaining traction and influential advocates in the United States, the economist Milton Friedman published a short essay titled "*The Social Responsibility of Business is to Increase its Profits.*" Possibly the most provocative single contribution to the history of business ethics, Friedman set out to show that large, publicly owned corporations ought to be about making money, and the ethical obligations imposed by advocates of CSR should be dismissed. His arguments convinced some and not others, but the eloquent and accessible way he made them, combined with the fact that his ideas were published in a mainstream publication — the *New York Times Magazine* — ensured their impact.

Friedman, M (1970) 'The social responsibility of business is to increase its profits,' *New York Times Magazine*, 13 September http://www.colorado.edu/studentgroups/libertarians/issues/friedman-soc-resp-business.html (Accessed 7 June 2011).

Businesses, as discussed at the chapter's beginning, come in all shapes and sizes. When the topic is social responsibility, however, attention frequently fixes on very large corporations because they are so big (and therefore able to do the most good) and powerful (the philosophies driving them tend to set the tone for business life in general). Friedman's essay concerns these large, publicly held corporations. Here are his arguments.

## The argument that businesses cannot have social responsibilities

*A business cannot have moral responsibilities any more than a wrench can. Only humans have moral responsibilities because only we have consciousness and intentions: we are the only things in the world that can control our actions, that can distinguish between what we want to do and what is right to do.* Therefore, only we can have responsibilities in the ethical sense. What, then, is a business? Nothing more than a tool, something we make to further our ends. It may work well or poorly, but no matter what, it does not do what it wishes, so we cannot blame or credit the business, only those individuals who use it for one purpose or another.

In Woburn, Massachusetts, according to this argument, it makes no sense to say that W. R. Grace has some kind of corporate responsibility to keep the environment clean. A company does not have any responsibilities. It is like a wrench, a thing out in the world that people use, and that is all. Would you accuse a wrench of being irresponsible if someone uses it to loosen the bolts on some truckers' tires and so causes an accident and disastrous spill of toxins? You would probably accuse the person who used the wrench of acting irresponsibly, but blaming the wrench for something would be madness.

## The argument that corporate executives are responsible only to shareholders

*Corporate executives are employees of the owners of the enterprise. They are contracted and obligated to conduct the business as the owners desire, not in accord with the wishes of some other people out in the world advocating broad social concerns.* Executives in this sense are no different from McDonald's burger flippers: they are hired and agree to do a certain thing a certain way. If they do not like it, they are free to quit, but what they cannot do is take the job and then flip the hamburgers into the trash because their friends are all texting them about how unhealthy McDonald's food is.

What do corporate owners desire? According to Friedman, the typical answer is the highest return possible on their investment. When you buy shares of the industrial chemical maker W. R. Grace, you check once in a while what the stock price is because price (and the hope that it is going up) is the reason you bought in the first place. It follows, therefore, that executives — who in the end work for you, the owner — are duty bound to help you get that higher share price, and the quickest route to the goal is large profits.

What about the executive who decides to dedicate time and a corporation's resources to social welfare projects (to things like reducing runoff pollution even further than the law requires or hiring released felons as a way of easing their passage back into society)? Friedman is particularly cutting on this point. It is despicable selfishness. There is nothing easier than generosity with other people's money. And that is what, Friedman hints, CSR is *really* about. It is about corporate executives who like the idea of receiving accolades for their generous contributions to society, and they like it even more because the cash does not come out of their paycheck; it is subtracted from shareholder returns. There is the seed of an argument here,

finally, that not only is corporate social responsibility not recommendable, it is reproachable: in ethical terms, corporate leaders are duty bound to refuse to participate in social responsibility initiatives.

## The argument that society will not be served by corporate social responsibility

*One serious practical problem with the vision of corporate executives resolving social problems is it is hard to be sure that their solutions will do good.* Presumably, corporate executives got to be executives by managing businesses profitably. That is certainly a difficult skill, but the fact that it has been mastered does not automatically imply other talents. More, given the fact that corporate executives frequently have no special training in social and environmental issues, it is perfectly reasonable to worry that they will do as much harm as good.

One example of the reversed result comes from *Newsweek*. Executives at the magazine probably thought they were serving the public interest when they dedicated space in their 28 April 1975, issue to the threatening and impending environmental disaster posed by global…cooling. Not a very enticing subject, they probably could have done more for their circulation numbers by running a story (with lots of pictures) about the coming summer's bathing suit styles, but they did the science to stoke broad discussion of our environmental well-being. As for the stoking, they certainly succeeded. Today, many scientists believe that global warming is the real threat and requires corporations to join governments in reducing carbon emissions. They have a hard time getting their message out cleanly, though, when there is someone around bringing up that old Newsweek article to discredit the whole discussion.

## The right institution for managing social problems is government

Social problems should not be resolved by corporations because we already have a large institution set up for that: government. If members of a society really are worried about carbon emissions or the disposal of toxic waste at chemical plants, then they should express those concerns to elected representatives who will, in turn, perform their function, which is to elaborate laws and regulations guiding the way all of us — inside and outside of business — live together. *Government, the point is, should do its job, which is to regulate effectively, and those in the business world should do their job, which is to comply with regulations while operating profitably.*

Underneath this division of labour, there is a crucial distinction. Friedman believes that human freedom is based to some significant degree in economic life. Our fundamental rights to our property and to pursue our happiness are inviolable and are expressed in our working activities. The situation is complicated, however, because it is also true that for us to live together in a society, *some* restrictions must be placed on individual action. No community can flourish if everyone is just doing what they want. There is room for quite a bit of discussion here, but in general, Friedman asserts that while government (and other outside institutions) have to be

involved in regulation and the imposing of limits, they should not start trying to mold and dictate basic values in the economic realm, which must be understood in principle as a bastion of individual liberty and free choices.

At this juncture, Friedman's essay reaches its sharpest point. The notion of corporate social responsibility, Friedman asserts, is not only misguided; it is dangerous because it threatens to violate individual liberty. Stronger, the violation may ultimately lead to socialism, the end of free market allocation of resources because rampant political forces take control in the boardroom.

The movement to socialism that Friedman fears comes in two steps:

1. Environmental activists, social cause leaders, and crusading lawyers will convince at least a handful of preening business executives that working life isn't about individuals expressing their freedom in a wide-open world; it's about serving the general welfare. The notion of corporate social responsibility becomes a mainstream concern and wins wide public support.

2. With the way forced open by activists, the risk is that government will follow: the institution originally set up to regulate business life while guaranteeing the freedom of individuals will fall into the custom of imposing liberty-wrecking rules. Under the weight of these intrusive laws, working men and women will be forced to give up on their own projects and march to the cadence of government-dictated social welfare projects. Hiring decisions, for example, will no longer be about companies finding the best people for their endeavours; instead, they will be about satisfying social goals defined by politicians and bureaucrats. Friedman cites as an example the hiring of felons. Obviously, it is difficult for people coming out of jail to find good jobs. Just as obviously, it is socially beneficial for jobs to be available to them. The problem comes when governments decide that the social purpose of reinserting convicts is more important than protecting the freedom of companies to hire anyone they choose. When that happens, hiring quotas will be imposed — corporations will be forced to employ certain individuals. This intrusive workplace rule will be followed by others. All of them will need to be enforced by investigating agents and disciplining regulators. As their numbers grow and their powers expand, freedom will be squeezed. Ultimately, freedom may be crushed by, as Friedman puts it, "the iron fist of Government bureaucrats."

Friedman, M (1970) 'The social responsibility of business is to increase its profits,' *New York Times Magazine*, 13 September http://www.colorado.edu/studentgroups/libertarians/issues/friedman-soc-resp-business.html (Accessed 7 June 2011).

It is difficult to miss the fact that Friedman's worries were colored by the Cold War, by a historical moment that now feels remote in which the world really did hang in the balance between two views of working life: the American view setting individual freedom as the highest value and the Soviet view raising collectivism and the general welfare above all personal economic concerns and liberties.

Still, and even though today's historical reality is quite different from the 1970s, the essence of Friedman's objection to CSR has not changed. It is that you and I get to be who we are by going out into the world and making something of ourselves. When our ability to do that gets smothered beneath social responsibility requirements, we may help others (or possibly not), but no matter what, we sacrifice ourselves because we have lost the freedom to go and do what we choose. This loss is not just an inconvenience or a frustration: it is the hollowing out of our dignity; it is the collapse of our ability to make ourselves and therefore the end of the opportunity to be someone instead of just anyone.

## The best way for corporations to be socially responsible is to increase profits

The final major argument against corporate social responsibility in its various forms is that the best way for most corporations to be socially responsible is to contribute to the community by doing what they do best: excelling in economic terms. *When corporations are making profits, the money is not just disappearing or piling up in the pockets of the greedy super rich (though some does go there); most of it gets sent back into the economy and everyone benefits. Jobs are created, and those that already exist get some added security.* With employment options opening, workers find more chances to change and move up: more successful corporations mean more freedom for workers.

Further, corporations do not get to be successful through luck, but by delivering goods and services to consumers at attractive prices. *Corporate success, that means, should indicate that consumers are doing well.* Their quality of life improves as their consumer products improve, and those products improve best and fastest when corporations are competing against each other as freely as possible.

What about the public welfare in the most general sense, the construction of parks, schools, and similar? Here, too, corporations do the best for everyone by concentrating on their own bottom line. More hiring, sales, and profits all also mean more tax revenue flowing to the government. And since elected governmental entities are those organisations best equipped to do public good, the most a corporation can hope for with respect to general social welfare is to succeed, and thereby generate revenues for experts (or, at least democratically elected officials) to divide up wisely.

The term *marketplace responsibility*, finally, names the economic and social (and political) view emerging from Friedman's arguments. The title does not mean ethical responsibility in the marketplace so much as it does the specific conception of ethical responsibility that the open marketplace produces. It has two aspects: first, the notion of corporate social responsibility is *misguided and dangerous*, and second, the *corporate purpose of profit maximisation serves the social welfare while cohering with the value of human freedom that should be paramount in business ethics.*

## Conclusion

Advocates of corporate social responsibility believe corporations are obligated to share the burden of resolving society's problems. They maintain that the responsibility stands on pure moral grounds. More, there are operational reasons for the responsibilities: if businesses are going to contaminate the environment or cause distress in people's lives, they should also be actively working to resolve the problems. Finally, there is the strong argument that even if the corporate purpose should be to make profits, social responsibility is an excellent way to achieve the goal. Advocates of marketplace responsibility — and adversaries of the corporate social responsibility model — argue that by definition corporations cannot have moral responsibilities. Further, to the extent ethical obligations control corporate directors, the obligations are to shareholders. More, corporate directors are not experts at solving social problems, and we already have an institution that presumably does have expertise: government. Finally, there is a strong argument that even if the corporate purpose should include broad social responsibilities, free individuals and corporations in the world making profits is an excellent way to achieve the goal.

### Activity 4.4

1. What does it mean to say that, in ethical terms, a corporation is no different from a wrench?

2. What primary responsibility do corporate directors have to shareholders? Why do they have it?

3. Why should social issues be managed by government and not corporations?

### Summary

Businesses can be organised in various ways. The way a business is organised affects economic questions about profits, legal questions about liability, and ethical questions about responsibility.

In sole-proprietorships and partnerships, owners take economic, legal, and moral responsibility for what the company does. In public corporations, owners are shielded from legal responsibility for the enterprise's actions; the question about moral responsibility remains open.

Corporations may have obligations that go beyond generating profits and include the larger society. Corporate social responsibility as a specific theory affirms that corporations are entities with economic,

legal, ethical, and philanthropic obligations. Corporations responsible for a triple bottom line seek sustainability in the economic, social, and environmental realms. Corporate ethics built on stakeholder theory seek to involve all those affected by the organisation in its decision-making process.

There are three broad arguments in favour of corporate social responsibility: it is morally required; it is required by externalities; it serves the interest of the corporation.

The arguments against the theories of corporate social responsibility are:

1. Corporations cannot have ethical responsibilities.

2. Corporate executives are duty bound to pursue profits.

3. Corporations are ill-equipped to directly serve the public good.

4. Social issues should be managed by government, not corporations.

5. Marketplace ethics reinforce human freedom and corporate social responsibility threatens society with socialism.

6. The best way for corporations to serve the public welfare is by pursuing profits.

**Self-test 4.1**

1. What kind of business organisation might be suitable for a plumber? Explain.

2. How can corporations raise money?

3. What does it mean for a corporate director to "balance stakeholder interests"?

4. List three ways a corporate bottom line may be improved by serving the public welfare.

5. What is the connection between corporate social responsibility and the threat to freedom posed by socialism? How does socialism limit freedom?

## Suggested answers to activities

### Feedback

**Activity 4.1**

1. There are a few kinds of organsations:

   a. Sole-proprietorship

   b. Partnership

   c. Limited liability company

   d. Non-profit organisation

   e. Corporation

2. LLP is essentially a hybrid entity that combines the characteristics of a corporation and a partnership or sole proprietorship. While the limited liability feature is similar to that of a corporation, the availability of flow-through taxation to the members of a LLP is a feature of partnerships. A LLC company's legal status provides some protection against liability lawsuits.

3. In 1819, the US Supreme Court defined a corporation as "an artificial being, invisible, intangible and existing only in the contemplation of the law." This legal independence clears the way for owners (founders / shareholders) to escape liability claims made against the corporation.

4. Corporations are legally protected by a liability firewall, and they are also protected structurally by the fact that they — along with the multitude of other owners (shareholders) scattered all over the country and even the globe — are not necessarily involved in making the company's operational decisions.

**Activity 4.2**

1. The responsibilities of the corporation include:

   a. The responsibility to make money and the responsibility to interact ethically with the surrounding community.

   b. The corporation's responsibility to profit while playing a role in broader questions of community welfare.

   In the event of conflict, corporate social responsibility for every business means four kinds of obligations and it should be responded in the following order: first the economic, then the legal, next the ethical, and finally the philanthropic.

2. At the intersection of ethics and economics, sustainability means the long-term maintenance of balance. As elaborated by theorists including John Elkington, the balance is defined and achieved economically, socially, and environmentally:

   a. Economic sustainability values long-term financial solidity over more volatile, short-term profits, no matter how high

   b. Social sustainability values balance in people's lives and the way we live.

   c. Environmental sustainability begins from the affirmation that natural resources — especially the oil fueling our engines, the clean air we breathe, and the water we drink — are limited.

3. Businesses hold three equally fundamental obligations: to produce sustainable results in the social, environmental and economic fields.

   a. Social fairness — As measured independently of other responsibilities, ensure the fair distribution of opportunity, wealth and welfare along the line of value-creation.

   b. Environmental stewardship — As measured independently of other responsibilities, contribute to the continuing livability of the planet.

   c. Economic growth and profit — As measured independently of other responsibilities, achieve bottom line results ensuring the business's long term viability.

The Fair Trade movement may be understood as an expression of sustainability in both economic and human senses.

4. The five cardinal stakeholders — shareholders, workers, customers, suppliers and community and anyone affected by the company's action (s).

5. Traditionally, the directors of companies have had an extremely difficult but very narrowly defined responsibility: guide the enterprise toward money. The basic element of CSR, The Triple Bottom Line and Stakeholder Theory centres around morality in the economic world. It is about the company directors sensing and responding to the broad range of social obligations where the business is located and its surrounding communities and through society.

**Activity 4.3**

1. The few reasons a corporation may feel directly responsible to the broad social obligations are:

   a. A corporation may feel morally responsible to the broad social world in order to justify the corporation's presence instead of the economic wellspring of money.

   b. A corporation may feel responsible towards the social world due to its operations. For example, a factory may emit significant air pollution which may results in high incidence of respiratory infections in the nearby township.

   c. A corporation practice CSR as part of their everyday business proved that a dedication to charitable initiatives goes a long way, both for the cause and their reputation and ultimately increased their profits.

2. Externalities occur where an economic actor takes a decision which results in actions that affect other parties without their consent. In most cases, the creator of the externality will be a corporation because they are the most important actors in modern economies.

   In normal business transactions, externalities may occur. These externalities are costs or benefits to third parties in a business transaction. For example, an industrial firm is considering

opening a plant in the United States. The proposed plant is known to emit a vast amount of pollutants that would seriously harm the environment and the health of citizens in close proximity.

Property rights and liability laws that hold a firm responsible for pollution will compel the firm to take those external costs into account; which the firms will internalise the external costs. The firm still maximises profits, but the profits account for the pollution costs now included in the cost of doing business.

**Activity 4.4**

1. A wrench is nothing more than a tool, something for us to use to further our ends. Only humans have moral responsibilities because we are the only ones that have consciousness and intentions. We are the only ones that can control our actions, can distinguish between what we want to do and what's the right thing to do?

2. The corporate directors' primary responsibility to the shareholders is to generate the highest profits for the corporation. This is because corporate executives are employees of the owners (shareholders) of the corporation. They are contracted and obligated to conduct the business of the corporation as the owners' desires, not in accord with the wishes of some people out the world advocating broad social concerns.

3. The government is the large institution setup to solve social problems. If members of a society really is concerned over carbon emissions or the disposal of toxic waste at chemical plants, then they should express those concerns to elected representatives who will, in turn, perform their function, which is to elaborate laws and regulations guiding the way all of us — inside and outside of business — live together. The government's job is to regulate effectively, and those in the business world should do their job, which is to comply with regulations while operating profitably.

# 4.2 Corporate Governance

## Objectives

By the end of this section, you should be able to:

1. Discuss the moral ecologies in corporate governance.
2. Define the concept of corporate governance.
3. Examine the theoretical approaches to corporate governance.
4. Outline the roles and responsibilities of the Board of Directors.

## Introduction

The tug of war between individual freedom and institutional power is a continuing theme of history. Earlier on, the focus was on the church; more recently, it was on the civil state. Today, the debate is about making corporate power compatible with the needs of a democratic society. The modern corporation has not only created untold wealth and given individuals the opportunity to express their genius and develop their talents but also has imposed costs on individuals and society. How to encourage the liberation of individual energy without inflicting unacceptable costs on individuals and society, therefore, has emerged as a key challenge.

Corporate governance lies at the heart of this challenge. It deals with the systems, rules and processes by which corporate activity is directed. Narrow definitions focus on the relationships between corporate managers, a company's board of directors, and its shareholders. Broader descriptions encompass the relationship of the corporation to all of its stakeholders and society, and cover the sets of laws, regulations, listing rules, and voluntary private-sector practices that enable corporations to attract capital, perform efficiently, generate profit, and meet both legal obligations and general societal expectations.

## Moral ecologies in corporate governance

### Two thought experiments

**The Ring of Gyges (Plato's Republic II, S359)**

Gyges, a poor shepherd, is tending his flock when there is an earthquake. A huge crack opens in the earth to expose a sarcophagus. Gyges reaches in and takes the ring that draws his attention. Later, when he is talking among friends, he notices that he becomes invisible when he turns the ring in toward himself. He tries this out a few times and then forms his plans. Invisible, he gains entry to the king's castle and rapes the queen. Drawing her into his nefarious plan, they kill the king

and take over the kingdom. Gyges marries the queen and becomes ruler of a large and wealthy kingdom. Somehow it does not seem fit to say that he lives "happily ever after." But, since he is never caught, it does not follow that his ill-gotten gain has made him miserable.

Before finding his ring, Gyges was, at least outwardly, a well-behaved, just citizen. But the combination of vast power and no accountability drew Gyges over to the dark side. Does the human character, like that of Gyges, dissolve in the face of temptation and lack of accountability? Is the threat of punishment necessary to keep individuals moral? Is visibility and the threat of punishment all that stands between an individual and a life of injustice?

**The Milgram Experiments**

From 1960 until 1963, Stanley Milgram, a social psychologist, carried out a series of experiments on around 1,000 subjects. Each experiment brought together three participants, a subject (or teacher), a learner, and an experimenter. In the initial orientation, the experimenter told the subject/teacher and the learner that they were about to participate in an experiment designed to measure the influence of punishment (in the form of electrical shocks) on learning. The learner was presented with information. The teacher then asked questions based on this information. If the learner answered correctly, then they went on to the next question. If the learner answered incorrectly, then he was given an electrical shock by the teacher. With each missed question the intensity of the shock increased. The experiment continued until all the questions were asked and answered.

However, these instructions constituted a deception brought upon the teacher/subject by the secret collaboration of the experimenter and the learner. The real purpose of the experiment was to determine how far individuals would go in turning against their moral views on the basis of an external authority. The learner feigned pain and suffering because there was no actual electrical shock. And the learner deliberately missed most of the questions in order to force the teacher to progress to higher and what appeared to be life-threatening levels of shock. While teachers were not physically forced to continue the experiment over the feigned protests of the learners, whenever they tried to stop it, they were told by the experimenter that they had to continue to the end.

Before the Milgram experiments were carried out, a group of psychogists were asked to predict how many teachers/subjects would go all the way to the end and give the learner what they thought were life-threatening and highly painful shocks. The consensus was that most would stop the experiment early on when the learner first began to protest. But the actual results were quite "shocking." Nearly 60 percent of the teachers went all the way and gave the learner the maximum shock.

You can read more about these experiments and how they have been interpreted by reading Milgram 1974 and Flanagan 1991. You Tube has several video vignettes on the Milgram Experiments. Simply type "Milgram Experiments" in the search window and browse the results.

Can authority and environment override our everyday moral beliefs as well as the characters constructed from them? Is character robust and "trans-situational?" Or is it radically dependent on situation and environment? Can normally decent and well-behaved individuals turn into moral monsters given the right external conditions?

### From Gyges and Milgram to moral ecology

Both of these thought experiments raise the question of the influence of environment on a character. This unit is designed to help increase the strength of moral character by identifying different organisational environments (called "moral ecologies") and help you develop strategies to resist their pressures and maintain integrity.

## Corporate governance defined

Corporate governance is defined in the Blackwell Encyclopedic Dictionary of Business Ethics as "concerned with those decisions made by the senior executives of a firm and the impacts of their decisions on various stakeholder groups" (EBE 147). This unit turns corporate governance inside-out and looks at it from the perspective of the governed, that is, from the directors, managers, and employees subject to the structures and strategies of corporate governance. Corporate environments function as "moral ecologies," that is, "the somewhat stable, but constantly negotiated set of values, practices, and influences within societies, organizations, professions, and work groups." (Huff et. al., 2008).

Perhaps the broadest, and most neutral, definition is provided by the Organization for Economic Cooperation and Development (OECD), an international organisation that brings together the governments of countries committed to democracy and the market economy to support sustainable economic growth, boost employment, raise living standards, maintain financial stability, assist other countries' economic development, and contribute to growth in world trade:

> *Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.*

The *Malaysian Code on Corporate Governance* (Code), first issued in March 2000, marked a significant milestone in corporate governance reform in Malaysia. The code was later revised in 2007 (2007 Code) to strengthen the roles and responsibilities of the board of directors, audit committee and the internal audit function. The *Malaysian Code on Corporate Governance 2012* (MCCG 2012) focuses on strengthening board structure and composition, recognising the role of directors

as active and responsible fiduciaries. They have a duty to be effective stewards and guardians of the company, not just in setting strategic direction and overseeing the conduct of business, but also in ensuring that the company conducts itself in compliance with laws and ethical values, and maintains an effective governance structure to ensure the appropriate management of risks and level of internal controls.

The eight (8) principles guiding the board from the MCCG (2012) are:

Principle 1: Establishing clear roles and objectives.

Principle 2: Strengthen composition.

Principle 3: Reinforce independence.

Principle 4: Foster commitment.

Principle 5: Uphold integrity in financial reporting.

Principle 6: Recognise and manage risks.

Principle 7: Ensure timely and high quality disclosure.

Principle 8: Strengthen relationship between company and shareholders.

**Reading**

Please read Reading 4.1 entitled "The Malaysian Code of Corporate Governance 2012". This article is available on WOU's *MyDigital Library* E-course reserve.

The focus of this section is to help you begin to strategise on how to develop sustainable moral careers within different moral ecologies. You will study different kinds of moral ecologies using a taxonomy developed from the research of Michael Davis in **Thinking Like an Engineer** and Robert Jackall in **Moral Mazes**. Huff (2008) provides some generic strategies for individuals to pursue within in these organisational environments. Working through this unit will help you to view corporate governance from within from the micro perspective of the individual. Another section will allow you to see corporate governance from the outside from the macro point of view.

## Personality characteristics: The "Big Five" (plus one)

So much of success in practical and professional ethics lies in anticipating and defusing potential ethical challenges. Called "Preventive Ethics," this approach encourages you to develop the skill of uncovering latent or hidden ethical problems that could erupt into full-blown ethical dilemmas. "An ounce of prevention is worth a pound of cure." This section is designed to help you reflect on your personalty, different organisational environments or ecologies, and how your personality fits into these moral ecologies. Your success depends on developing plans for successful moral careers that respond to your personality traits and resist ethical challenges presented by organisational environments.

## Personality characteristics: Find your place on the continuum

1. Extraversion _____ Introversion

2. Neuroticism _____ Emotional Stability

3. Conscientiousness _____ Carelessness.

4. Agreeableness _____ Disagreeableness

5. Openness (to experience _____ Closed (to experience)

6. Honesty/Humility _____ Dishonesty/Arrogance

This account of personality modifies the one presented by Huff et al., in "Good computing: a pedagogically focused model of virtue in the practice of computing, parts 1 and 2."

## Three moral ecologies

This table and the explanatory material below summarises materials from studies reported by Davis (Thinking Like an Engineer) and Jackall (Moral Mazes). You should be aware that it departs somewhat from the strictly reported results in order to adopt the results to the idea of moral ecology. This later idea was introduced by R. Park in Human Communities: The City and Human Ecology, Free Press, Glencoe, IL, 1952.

| Type / Characteristics | Managers and engineers: role and participation | Centrality of ethics and values | Allocation of praise and blame | Withholding information | Treatment of dissent and DPOs (Dissenting Professional Opinion) |
|---|---|---|---|---|---|
| Finance-driven | Managers play line role (make decisions) Engineers provide technical information (staff role). | Ethics and values are side constraints dealt with when they oppose financial considerations. | Allocated according to hierarchical position: praise goes up and blame goes down. | Managers withhold to control and protect secrets. Engineers withhold bad news to avoid blame. | "Shoot the messenger!" Dissent = disloyalty and betrayal. |
| Customer-driven | Managers make decisions on financial matters. Engineers "go to the mat" on engineering matters. | Ethics and values are not central but are still important. | Praise and blame are fairly allocated based on assigned responsibility and contribution. | Information not withheld but gaps arise because or role differences. | Differences occur but engineers are expected to advocate their perspective in decision making process. |
| Quality-driven | Manager and engineering distinction drops out. Interdisciplinary work teams are empowered and responsible. | Ethics and values are constitutive of the organisation's identity. | Praise and blame are attributed to group and distributed to individuals within according to contribution. | Open consensus process ensures that needed information is integrated into decision making. | Engineers and managers work toward consensus by gathering more information, continuing the discussion, and (as last resort) postponing the decision until consensus is reached. |

**Table 4.2** Summary of characteristics by Davis and Jackall

The summary of the table is as follows:

Moral ecologies can be categorised according to a series of considerations. The table above focuses on five.

1. First consideration, managers and engineers occupy distinct roles and participate differently in the decision making process. Managers play the **line** role. They collect information to make decisions that govern the day to day operations of the corporation. Engineers are hired as **staff** employees. They provide technical information to decision makers but do not participate directly in the decision-making process. This raises difficulties when engineers, for technical or ethical reasons, disagree with the decisions taken by their managers. The line and staff roles channel decision making and constrain dissent.

2. Second consideration. Moral ecologies can also be typed according to the centrality of ethical considerations in the corporation's goals, charter, operations, and even identity. Ethical considerations can range from (a) playing a **central** role; (b) to playing an important but **subordinate** role; (c) to being marginalised as irrelevant **side constraints**. The importance a corporation places on ethics colors all the other categories mentioned in **Table 4.2**. If ethics is central to a corporation then it plays a central role in the decision-making process, guides the allocation of praise and blame, determines the nature and amount of information shared in the decision-making process, and determines how an organisation treats dissent and disagreement.

3. Third consideration. A corporation's conception of responsibility is revealed through the ways in which it allocates praise and blame. Significant differences arise between the way finance companies assign praise and blame and the ways these are allocated in quality or customer driven companies. Again, this related to the roles played by engineers and managers and the centrality of ethics in the corporation's governance.

4. Fourth consideration. Ethical problems arise when crucial information is withheld from the decision-making process. Hence, the flow of communication and the kinds of situations in which communication flow is disrupted helps to characterise a moral ecology. For example, the Hitachi report asserts that communication between managers and engineers breaks down predictably within finance-driven companies. This breakdown is grounded in the characteristics of the finance-driven moral ecology, especially in differences between the managerial and engineering roles and the extent to which managers and engineers participate in decision making.

5. Finally, moral ecologies can be classified according to how they treat dissent and dissenting professional opinions. Dissent is less likely in quality than in finance-driven companies. While finance-driven companies treat dissent as disloyalty, quality- and customer-driven driven companies treat dissent as a stage in the process of reaching consensus.

## Finance-driven companies

Finance-driven companies place financial objectives at the very heart of their constitutive objectives and corporate identity. For example, such companies are focused on maximising returns for investors.

1. **Manager and engineer roles and participation in decision-making process**: Managers play the line role in that they make the decisions that drive the day-to-day operations of the corporation. They bear responsibility for the consequences of their decisions and they are also responsible as the faithful agents of the company's directors. Being a faithful agent requires that one treat another's interests as one's own, maintain confidentialities, and avoid interests that conflict with the director. Engineers play the staff role, that is, they answer questions put to them by managers and are responsible for providing competent technical information. However, they do not participate directly in the decision-making process, nor do they bear responsibility for the results of their manager's decisions.

2. **Centrality of ethics and values in the corporations' decision-making process**: Ethical considerations play only the role of side constraints in the setting of corporate policy and in the formulation and execution of its decisions. This means that ethical considerations are important only if they promote or interfere with the central, financial objectives. If appearing philanthropical is good for a corporation's image (and generates customers and profits) then the corporation appears philanthropic. If the corporation is likely to get caught in an ethical violation (excessive pollution) and this negative publicity will lower its prestige (and profits) then the corporation will not commit the violation. But in each case, the end is the promotion of financial objectives and the means are appearing ethical.

3. **Allocating praise and blame**: Jackall goes into detail on how finance-driven corporations (and bureaucracies in general) assign praise and blame. The crucial factor is one's position in the corporate hierarchy. Praise works its way up the corporate ladder. If engineer Smith saves the company from a severe financial loss, then Smith's supervisor (or his supervisor's supervisor) gets the credit. However, if Smith's supervisor messes up, the blame passes down the corporate ladder to Smith. Praise moves up the corporate hierarchy, blame down.

4. **Information exchange between engineers and managers**: In finance-driven companies, managers withhold information from the engineers under their supervision for a variety of reasons. For example, if it is proprietary information, the manager may withhold all or part to prevent engineers from leaving the firm and revealing its secrets to a competitor. Managers may also use information to wield power and authority. By keeping engineers in the dark (like mushrooms) they effectively maintain authority and prevent dissent. On the other hand, engineers withhold bad news from their managers to avoid blame as well as the "shoot the messenger" syndrome. (When the incompetent general receives bad news from a soldier, he shoots the soldier rather than respond to the news.)

5. **Handling dissenting professional opinions**: Dissent is interpreted as disloyalty in finance-driven companies. This organisational habit (maintained by managers to hold on to their authority) will even undermine DPO (Dissenting Professional Opinion) procedures that look good on paper. A good DPO procedure communicates the opinion to several levels of supervisor, allows for the independent investigation of the merits of the opinion, and prevents retaliation against the professional asserting the opinion. But ruthless managers find ways to undermine such a procedure at all levels. Engineers may claim the right not to be held as scapegoats to administrative incompetence. This right may be supported on paper by a detailed DPO procedure. But it also has to be implemented at all levels and continually monitored.

## Customer-driven companies

Customer-driven companies focus on customer satisfaction. If the customer asks for or is satisfied with a lower quality product, then this is an acceptable result for this type of company as opposed to a quality driven company which would stand fast with the higher quality product.

1. **Managers and engineers: Roles and participation**: Managers make decisions on financial matters. But engineers are expected to "go to the mat" for engineering standards when these form all or part of the decision. Hence the distinction between managers (playing the line role) and engineers (playing the staff role) weakens, and engineers play a much more active role (advocates for engineering standards) in decision making. (Engineering standards include engineering ethics standards.)

2. **Centrality of ethics and values**: While customer satisfaction plays the central role, ethical considerations are still important, especially regarding the ethical treatment of customers and reflecting the ethical values held by the customers. In many cases, it is difficult to distinguish quality and customer driven companies as the role ethical standards play gets closer to a central, constitutive one.

3. **Allocation of praise and blame**: Responsibility in customer-driven companies is tied closely to individual performance and contribution. This is because customer satisfaction is a more objective criterion than the internal political standards that dominate finance driven companies. Responsibility is closely alligned with contribution.

4. **Withholding information**: Information enhances control and responsibility. (The more you know, the more responsibly you can act.) Since praise and blame are allocated according to contribution, there is less incentive to withhold information. If communication gaps arise between engineers and managers, these are much more likely to hinge on disciplinary differences. Engineers may have trouble communicating technical information to managers, or appear condescending by "dumbing down" the information. Managers may have difficulties communicating financial constraints to engineers who focus on quality standards. But these are minor, resolvable gaps.

5. **Treatment of dissent**: Dissent and disagreement are not only tolerated but actually expected. Managers expect engineers to advocate for issues in their sphere as they pertain to the decision-making process. This process itself is adversarial because it is assumed that this is the best way to get all the information out on the table. Bad news and professional dissenting opinions are not interpreted as disloyalty; in fact, disloyalty lies in refusing to expose flaws in the choices proposed by one's supervisor. Managers expect their engineers to "go to the mat" when advocating technical positions based on their professional judgement.

## Quality-driven companies

Quality-driven companies stand out for the emphasis they place on achieving high engineering standards and on elevating the participation of the engineer in the decision-making process. As is implied by the name, the central focus of these corporations is the achievement of high quality in products and services.

1. **Managers and engineers: Role and participation**: In quality-driven companies, the distinction between the manager and engineering roles drops out. For example, while engineers play the staff role and provide expert engineering advice, they also participate fully in the decision-making process. The locus of decision making moves from individual managers to small interdisciplinary groups. These groups, in turn, carry out consensus-based decision-making procedures.

2. **Centrality of ethics and values**: In quality-driven companies, ethics and values are central to the organisation's objectives, charter and identity. This has a decisive impact on the role of the engineer in the decision-making process. In customer-driven companies, engineers are expected to advocate engineering and ethical standards precisely because these are not central to the organisation's identity. But the centrality of ethical concerns in quality driven companies changes the engineer's role from advocacy to channeling technical expertise toward realising ethical value.

3. **Allocation of praise and blame**: In customer-driven companies, blame avoidance procedures no longer dominate the decision-making process. In quality-driven companies they disappear completely. Decisions are made by interdisciplinary groups in which engineers and managers participate fully and equally. Responsibility (praise and blame) then is allocated to the group. If it is distributed to members inside the group it is done so on the basis of contribution. But the primary target of responsibility ascriptions is the group, not the individual. And the response to untoward happenings is not targeting individuals and groups for blame but taking measures to learn from mistakes and avoiding them in the future.

4. **Withholding information**: The open, consensus-based decision process ensures that the needed information is brought forth and integrated into the decision. This resulted from removing a primary motivation to

withholding information, namely, blame avoidance. Quality-driven corporations aggressively move to prevent untoward occurrences and, should prevention fail, make adjustments to ensure they do not reoccur. The motive to withhold information does not arise in this moral ecology.

5. **Treatment of dissent and DOPs (Dissenting Professional Opinions)**: Engineers and managers work toward consensus by gathering information, discussing the problem and continuing the discussion until consensus is reached. Thus, dissent does not stand alone but is considered to be an essential and healthy component to the decision-making process. When consensus is not immediately reached, participants seek more information. If consensus is still not reached, the decision is postponed (if this is possible). The most viable strategy to reach consensus is to continue the discussion. For example, an engineer and manager might approach a supervisor; in this way they bring a new perspective into the decision-making process. They might consult other experts. The crucial point here is that disagreement (really non-agreement) is not a bad thing but a necessary stage in the process of reaching agreement and consensus.

Skill sets, personality traits and kinds of moral expertise are discussed in detail by Huff et al., "Good computing: a pedagogically focused model of virtue in the practice of computer, parts 1 and 2." These are published in *Information, Communication and Ethics in Society*, Emrald Group Publishing Limited, vol. 6, no: 3 and 4 in 2008.

In summary, they are:

## Skill sets

The four skills described below are derived from studying the moral expertise displayed by moral exemplars. Each moral ecology will require the exercise of each of the skills described below. However, each skill has to be contextualised into the moral ecology. For example, reasonableness should not be exercised in the same way in a finance-driven company as it should be exercised in a quality-driven company. The reasonable exercise of dissent is manifested differently in an environment where dissent is equated with disloyalty than in one in which dissent is embraced as a necessary part of the consensus-reaching process. So your job, in constructing your moral careers within these different moral ecologies, is to contextualise the skill, that is, describe specifically how each skill should be practiced in each particular moral ecology.

1. **Moral imagination** consists of projecting oneself into the perspective of others. It also includes multiple problem definitions and the ability to distance oneself from the decision situation to gain impartiality.

2. **Moral creativity** is the ability to generate non-obvious solutions to moral challenges while responding to multiple constraints.

3. **Reasonableness** consists of gathering relevant evidence, listening to others, giving reasons for one's own positions (arguments and evidence), and changing plans/positions only on the basis of good reasons.

4. **Perseverance** involves planning moral action and responding to unforeseen circumstances while keeping moral goals intact.

## Personality traits

1. **Extraversion**: Extraversion, which is paired with its opposite, introversion, has also been called confident self-expression, assertiveness, social extraversion and power. An individual in whom this trait dominates tends to be assertive and out-going.

2. **Conscientiousness**: Individuals with this trait are successful in carrying out tasks because they can discipline themselves to stay focused on a task. They are successful in the right moral ecology and tend to conform to the basic norms of their environment. This trait can lead to bad results if not guided by moral considerations.

3. **Neuroticism**: This trait indicates a lack of emotional stability. According to Huff et al., "it is correlated with less effective coping and depression." Neuroticism has also been shown to interfere with the exercise of moral skills. Is there a particular moral ecology that can heighten the negative impacts of this personality trait?

4. **Agreeableness**: According to Huff et al., this trait has also been called "social adaptability, likability, friendly compliance and love." Again, think about how this trait would operate within a finance-driven moral ecology as opposed to a quality-driven one.

## Two kinds of moral expertise

1. Studies carried out by Chuck Huff into moral exemplars in computing suggest that moral exemplars can operate as crafts persons or reformers. (Sometimes they can combine both these modes.)

2. Crafts persons (a) draw on pre-existing values in computing; (b) focus on users or customers who have needs; (c) take on the role of providers of a service/ product; (d) view barriers as inert obstacles or puzzles to be solved; and (e) believe they are effective in their role.

3. Reformers (a) attempt to change organisations and their values; (b) take on the role of moral crusaders; (c) view barriers as active opposition; and (d) believe in the necessity of systemic reform.

These descriptions of moral exemplars have been taken from a presentation by Huff at the STS colloquium at the University of Virginia on October 2006.

**Activity 4.5**

1. In your own words, how would you define corporate governance?

2. What are the five considerations moral ecologies can be categorised?

## Different approaches to corporate governance

The major recent corporate scandals from the late 1980s to the early 2000 were fundamental reasons for government to incorporate more stringent regulations on governance to the public listed companies to protect the shareholders and stakeholders interest.

### Arthur Andersen

Once a highly respected company, Arthur Andersen no longer exists, having gone bankrupt in the wake of the Enron disaster. Arthur Andersen provided Enron with consulting and accounting services. The consulting division was more successful but the accounting division, with its long tradition of outstanding ethical service, was the corporation's backbone. Arthur Andersen signed off on Enron's use of mark-to-market accounting which allowed Enron to project optimistic earnings from their deals and then report these as actual profits years before they would materialise (if at all). They also signed off on Enron's deceptive use of special purpose entities (SPE) to hide debt by shifting it from one fictional company to another. With Arthur Andersen's blessing, Enron created the illusion of a profitable company to keep stock value high. When investors finally saw through the illusion, stock prices plummeted. To hide their complicity, Arthur Andersen shredded incriminating documents. For federal prosecutors, this was the last straw. The Justice Department indicted the once proud accounting firm, convinced that this and previous ethical lapses (Sunbeam and Waste Management) showed a pattern of unabated wrongdoing. Arthur Andersen was conficted of obstructing justice on 15 June, 2002 and closed its doors shortly after.

McLean and Elkind provided background for this profile on Arthur Andersen. See below for complete reference.

*Arthur Andersen Timeline* (Taken from Smartest Guys in the Room)

- 1913 — Founded by Arthur Andersen: "think straight, talk straight"

- Stood up to Railroad company in early years. When asked to change accounting standards, Andersen said, "There is not enough money in the city of Chicago [to make AA give into client demands]".

- 1947 – 1963 — Leonard Spacek became president of AA succeeding Arthur Andersen.

- Spacek helped motivate the formation of the Financial Accounting Standards Board. AA also served as conscience of accounting profession criticising the profession and the SEC (Securities and Exchange Commission) for "failing to square its so-called principles with its professional responsibility to the public."

- 1963 – 1989 — Slow erosion of standards and development of competition between accounting and consulting divisions. (Consulting division was developed to take advantage of a profitable direction in the financial industry.)

- 1989 — Consultants achieve relative autonomy as "separate business unit." (McLean: 144)

- 1997 — Consultants break from firm.

- 1988 – 1991 — Arthur Andersen receives 54 million in fees from Enron.

- 2000 — Enron pays AA 52 million. The lion share of this was for consulting fees.

- June 15, 2002 — AA found guilty of obstruction of justice. "Today's verdict is wrong....The reality here is that this verdict represents only a technical confiction." (McLean: 406)

## Hughes Aircraft

Howard Hughes founded this company at the beginning of the twentieth century. Hughes became a regular supplier of military hardware to the U.S. military. In the 1980's, this included parts for surface to air missiles and fighter aircraft. One division specialised in computer chips designed to convert analogue information to digital for use in guidance systems and decision support systems. For example, these chips interacted with radar to help pilots of fighter aircraft avoid enemy missiles and also served as an essential component for missile guidance systems, the so-called smart bombs. Hughes had won the competitive bids for these highly profitable military projects but they had also committed themselves to tight delivery schedules with inflexible deadlines. And on top of this, the U.S. Airforce demanded that these computer chips and the systems that integrated them be rigorously tested to show that they could withstand the severe environmental stresses of battle. Hughes soon fell behind on the delivery of these computer chips causing a chain reaction of other delays both within the company and between the company and other links in the military supply chain. The environmental tests carried out by quality control under the supervision of Frank Saia had worked hard to complete the time-consuming

tests and still remain on schedule with deliveries; hot parts (parts in high demand) were pulled to the front of the testing line to keep things running but soon even this was not enough to prevent delays and customer complaints. Giving way to these pressures, some Hughes supervisors pushed employees to pass chips without testing and even to pass chips that had failed tests. Margaret Gooderal and Ruth Ibarra resigned from the company and blew the whistle on these and other ethical failings that had become rampant in Hughes. So the corporate social responsibility question becomes how to change this culture of dishonesty and restore corporate integrity to this once innovative and leading company. (Background information on Hughes can be found at computingcases.org.)

## *Patricia Dunn* v. *Tom Perkins* on corporate governance

When Patricia Dunn became a "non-executive" chairman of Hewlett-Packard's board on 7 February, 2005, she brought with her an outstanding reputation in corporate governance. Her top priorities were to oversee the election of a new CEO after the firing of Carly Fiorina whose management of the recent acquisition of Compaq had lost her the HP board's support. Dunn was also determined to stop leaks to the press from high-level HP officials. She viewed the latter task as a fundament component of the post-Enron corporate governance approach she felt was needed as Hewlett-Packard moved into the 21st century. But her formal take on CG was at odds with powerful board member and successful venture capitalist, Tom Perkins. In his opinion, too strict an approach to CG stood in the way of HP culture and took focus away from competing with Dell and IBM as well as staying on the cutting edge in the development of new technology. As the leaks continued, Dunn's investigation into their source (most likely a discontented HP board member) became more active and rigorous. And the disagreements between her and board member Perkins deepened; their incompatible views on CG (and other disagreements) led to Perkins's resignation from the HP board. Things became critical when Perkins received a letter from A.T. and T. informing him that an account had been established in his name (but without his knowledge or consent) using the last 4 digits of his social security number and his private phone number. During the HP-led investigation into the press leaks, a private investigation firm used an illegal technique known as "pretexting" to obtain confidential information about HP board members and news reporters including private phone and social security numbers. Perkins reported this to the SEC, and Patricia Dunn, as chairman and de facto head of the leak investigation, was indicted on four criminal charges including identity theft.

James B. Stewart, in a *New Yorker* article about Patricia Dunn and Hewlett-Packard, describes corporate governance as "a term that technically refers to all aspects of running a corporation but in recent years has come to emphasise issues of fairness, transparency, and accountability." This unit looks at corporate governance from the macro perspective, (1) examining the management strategies adopted by a firm to ensure compliance and pursue excellence; and (2) from the standpoint of government as it seeks to minimise unethical corporate behaviour and to maximise the corporation's contribution to social welfare.

## Prisoner's dilemma: Cooperation or competition?

Scholarly debates on corporate governance have turned on the advocacy of different approaches, many of which can be modelled mathematically. Two approaches are based on the concepts of agency and stewardship. (See Davis et. al. in Clarke 2004) To enter into this debate, you will reenact the "Prisoner's Dilemma." Imagine that two patriotic spies, A and B, have just been captured by the enemy. Both are placed in separate interrogation cells and are being pressured to confess and provide details about their spying activities. A and B would like to coordinate their actions but the enemy has kept them apart to prevent this. Their objective is to pit A against B another in order to get the desired information. To do this, they have set forth the following systems of motivations, i.e., punishments and rewards.

## Options for the prisoners

- **If both A and B confess**. A and B are put in jail for five years each. The net loss in this scenario is 10. This is the least desirable alternative from the collective standpoint.

- **If one confesses and the other does not**. The confessor is released immediately while the non-confessor gets seven years in prison. This maximises the confessor's self interest but severely punishes the patriotic, non-confessor. Net loss is 7.

- **If both do not confess**. After six months of half-hearted interrogation (most of this time is for processing the prisoners' release), both are set free for lack of evidence. While not maximising self-interest (this lies in confessing while the other remains silent) this does maximises overall welfare by producing a net loss of only 1.

| Prisoner A / Prisoner B | Confess | Not Confess |
|---|---|---|
| Confess | Both go to jail for 5 years (Net loss is 10) | A goes to jail for 7 years. B is released. (Net loss is 7) |
| Not Confess | B goes to jail for 7 years. A is released (Net loss is 7) | Both held for six months, then released. (Net loss is 10) |

**Table 4.3** Assumptions in the prisoner dilemma

*Prisoner dillema options summarised*

1. Cooperation produces the best collective option and the second best individual option. This, in turn, assumes that cooperation produces more social welfare than competition.

2. Free riding (competing) on the cooperation of others produces the most individual gains (for the free rider) but the second worst collective results. Society suffers loses from the harm done to the trusting, non-confessor and from the overall loss of trust caused by unpunished free-riding.

3. Unlimited, pure competition (both prisoners confess) produces the worst collective results and the second worst individual results.

4. Multiple iterations of the prisoner's dilemma eventually lead to cooperative behaviour. But what causes this? (a) The trust that emerges as the prisoners, through repeated iterations, come to rely on one another? Or (b) the fear of "tit-for-tat" responses, i.e., that free riding on the part of one player will be punished by free riding on the part of the other in future iterations?

5. Does the Prisoner's Dilemma assume that each player is a rational, self-interest maximiser? Are the players necessarily selfish in that they will seek to maximise self-interest even at the expense of the other players unless rewards and punishments are imposed onto the playing situation from the outside?

The Prisoner's Dilemma is designed to model the reality of corporate governance where the directors/owners of a corporation delegate responsibility for the corporation's operations to managers who are charged with pursuing, not their own interests, but those of their directors. The problem of corporate governance is how this cooperative arrangement is institutionalised. Can managers be left alone and trusted to pursue the best interests of the corporation? This is implied in stewardship theory. Or is it necessary to design a system of controls to keep the managers from diverting the operations of the corporation toward their exclusive, self-interests? This is the approach taken in agency theory. Modeling this in terms of repeated iterations of the prisoner's dilemma, does cooperation emerge as the most reliable strategy in the long run? Or does it need to be manufactured by introducing a system of incentives such as fear of tit-for-tat strategies? The Prisoner's Dilemma models the central problems of corporate governance by asking whether cooperation naturally emerges between managers and directors or whether it needs to be manufactured through a system of punishments and rewards.

The Prisoner's Dilemma is discussed throughout the literature in business ethics. For a novel and insightful discussion in the context of corporate responsibility see Peter A. French, P A (1995) *Corporate Ethics* from Harcourt Brace College Publishers.

## Approaches to corporate governance

In this section, we shall examine several corporate governance theories namely agency theory, stockholder theory, stakeholder theory and stewardship theory. The two most common theory used in accounting and finance are the agency theory and stakeholder theory.

## Agency theory

1. In agency theory, *the owners/directors set the central objectives of the corporation*. Managers, in turn, are responsible for executing these objectives in the corporation's day-to-day operations. Corporate governance consists of designing structures and procedures to control management, i.e., to keep their actions in line with director-established objectives.

2. Managers cannot be trusted to remain faithful agents, i.e., to stay faithful to the interests and goals of the owners/directors. This presupposes a particular view of human nature. Humans are rational, egoists. They have desires and use reason to devise means to realise them. Since one desire can be checked only by another desire, this egoism is potentially without limit. Agency theory assumes that *managers will divert corporate resources to pursue their own selfish ends unless checked by some system of external controls*. Thus, another key element of corporate governance under agency theory is to *find the most efficient systems of controls to keep manager egoism in check*.

3. *The owners/directors play the role of principal in agency theory*. T*he principal originates the action and bears primary moral and legal responsibility for it*. Most of the time the principal of an action is also its executor. But there are times when the principal lacks the knowledge and skill necessary for executing the objectives he or she originates. In this case, the principal contracts with an agent. The principal authorises the agent to act on his or her behalf. This requires that the agent remain faithful to the goals and interests of the principal. See Hobbes' Leviathan, Chapter 16 for an important historical account of the agent-principal relation.

4. *Managers are agents. Their primary responsibility is to serve as faithful executors of the goals and interests of the principals*. This requires, first, that, managers are responsible for exercising their professional judgement in a competent way. Managers are also responsible for remaining faithful to the interests of their principals. To do this they must avoid conflicts of interests and maintain confidentialities (i.e., keep secrets). Agent can also range from being free (unguided by principals) to bound (tightly monitored and controlled by principals).

5. How does ethics enter into corporate governance under agency theory? Primary emphasis is placed on compliance, i.e., enforced conformity to rules that constitute minimum thresholds of acceptable behaviour. Compliance approaches develop (a) rule based codes; (b) systems of monitoring to detect violations;

and (c) punishments and rewards to deter non-compliance and reward compliance. Trevino and Weaver provide an empirical analysis to the goals achieved through compliance ethics: "[d] the perception that better decisions are made because of the ethics program; [e] ethical advice seeking; [f] decreased unethical behavior in the organization...;[g] ethical awareness." (Weaver and Trevino, 1999: 333.)

## Stockholder theory

1. *The stockholder approach is quite similar to that set forth in agency theory*. The difference is that *it views the corporation as the property of its owners (stockholders) who may dispose of it as they see fit. Most of the time this involves using it to receive maximum return on investment.*

2. *Stockholders are oriented toward self-interest, so stockholder theory, along with agency theory, takes an egoistic/Hobbesian view of human nature*. Humans are rational, self-interest maximisers. Owners should expect this from the corporation's managers and employees. They should integrate procedures and controls that channel the corporation and its members in the direction of their (owners) self-interest.

3. *The owners invest in the corporation and seek a return (profit) on this investment*. But this narrow role has been expanded into overseeing the operations of the corporations and its managers to ensure that the corporation is in compliance with ethical and legal standards set by the government. Just as the master, under tort law, was responsible for injury brought about by the negligence of a servant, so also are directors responsible for harm brought about by their property, the corporation.

4. *Managers are role-responsible for ensuring that investors get maximum return on their investment*. This includes exercising good business judgement and avoiding conflicts of interests and violations of confidences.

5. *Like corporations operating within agency theory, stockholder corporations focus on compliance strategies to monitor managers and make sure they remain faithful agents.* However, directors under the stockholder approach also take oversight responsibility seriously which include ensuring corporate compliance with laws such as Sarbanes-Oxley and the Federal Sentencing Guidelines.

## Stakeholder theory

1. *Owners drop out of the center of attention in this approach to become one of several, equal stakeholders. A stakeholder is any group or individual that has a vital interest, right, good, or value in play or at risk*. (A gambler's stake is the money on the table in play as the roulette wheel turns. Depending on the outcome of the situation, the gambler either keeps or loses the stake.) Examples of corporate stakeholders include stockholders, employees, customers, suppliers, local community, and government. The corporation on this view exists for the sake of its stakeholders, not stockholders.

2. *The stakeholder view can be closely tied to egoism if it is assumed that the different stakeholder groups exist to maximise their selfish interests*. But the stakeholder approach to corporate governance goes beyond the egoistic account of human nature. The corporation (and its managers) becomes responsible for mediating between these different, often conflicting, stakeholder interests, always keeping in mind that all stakeholders deserve equal respect. If stakeholders have any solidarity with one another, it is because the interest set of each includes the interests of the others. (This is how Feinberg defines solidarity.) The ability to envision the interests of each stakeholder and to work toward integrating these must be built on a view of human nature that is as altruistic as egoistic. While not embracing the social view of human nature outlined above, the stakeholder view assumes that stakeholders are capable and willing to negotiate and bargain with one another. It begins, in other words, with enlightened and long term self interest.

3. *The first feature of the owner role is the reduction in centrality mentioned just above*. They advocate their interests in the same arena as the other stakeholders, but they also must work to make their interests compatible with the other stakeholders. This requires integrating interests when possible and drawing integrity-preserving compromises when necessary.

4. *Managers play an important meta-role here*. They are faithful agents but of all stakeholders, not just stockholders. Thus, they become referees or (to switch metaphors) brokers between stakeholders. They oversee the generation of expansive corporate values capable of absorbing and integrating narrower stakeholder interests.

5. *Stakeholder approaches combine compliance and value-based approaches*. In compliance, corporate officers define a moral and legal minimum; this consists of the minimum set of rules necessary for stakeholder coexistence. Beyond this, value-based approaches seek to create common, broader objectives, aspirations that can unite the different stakeholders in the pursuit of excellence. Stakeholder approaches need both; the compliance approach gets things started and the values-based approach sets them on the path to excellence.

## Stewardship theory

1. *Managers and employees can be trusted to act as stewards or guardians of the corporation*. This means that while they do not own the corporation's resources, they will safeguard these for the owners. A steward is a caretaker who looks after the owner's property and interests when the owner is absent.

2. *This approach definitely makes use of the social approach to human nature. Humans, naturally and spontaneously, realise their innermost natures by forming social unions*. The corporation, under this view, is such an organisation. While taking on the characteristics of a social contract with the other approaches, especially agency theory, the corporation under the stewardship view is more of a cooperative, collaborative enterprise. Humans can act and find meaning in interests and concerns well beyond the confines of the ego. In fact, to organise the corporation around egoistic assumptions does harm to those capable of action on altruistic motives. The emphasis here is on building trust and social capital to strengthen the social potentialities of human nature.

3. *Owners still establish the cardinal objectives for the sake of which the corporation exists*. But they are also responsible for providing managers with an environment suitable developing human potentialities of forming societies to collaborate in meaningful work.

4. *Managers act as stewards or caretakers; they act as if they were owners in terms of the care and concern expressed for work rather than merely executors of the interests of others*. In other words, the alienation implied in agency theory (acting not out of self but for another), disappears as the managers and employees of the corporation reabsorb the agent function.

5. *Stewardship approaches are primarily value-based*. They (a) identify and formulate common aspirations or values as standards of excellence; (b) develop training programmes conducive to the pursuit of excellence; and (3) respond to values "gaps" by providing moral support.

**Table 4.4** summarises materials from *Introduction: Theories of Governance* (Clarke, 1 through 30) and provides a taxonomy of several different approaches to corporate governance.

| (1,1) | Description(1,2) | Theory of Human Nature(1,3) | Owner Role(1,4) | Manager Role(1,5) | Corporate Ethics Focus(1,6) |
|---|---|---|---|---|---|
| Agency Theory(2,1) | Managers act as agents of the corporation fulfilling the goals established by the owners / directors(2,2) | Managers are rational, but self-interested beings who must be controlled from the outside(2,3) | Owners are principals, that is, they originate the action and bear primary moral responsibility.(2,4) | Managers are agents, that is, responsible for acting in the interest of the principals who hire them. Faithful agency implies avoiding conflicts of interests and maintaining confidences.(2,5) | Compliance focus uses (1) rule-based codes, (2) systems of monitoring, and (3) punishments and rewards to motivate compliance from outside.(2,6) |
| Stockholder Approach(3,1) | Corporation is property of stockholders who dispose of it as they see fit.(3,2) | Stockholders pursue self interest. They are rational (instrumental), economic self-interest maximisers.(3,3) | Owners invest in corporation and seek a return (profit) on their investment.(3,4) | Managers are responsible for ensuring that owners get maximum return on investment.(3,5) | Stockholders direct compliance toward manager control and external conformity to laws.(3,6) |
| Stakeholder Approach(4,1) | Owners drop out of center focus. Corporation is run for the sake of its stakeholders. (4,2) | Groups have special interests but recognise the need to integrate these. Humans possess capacity for procedural reasoning.(4,3) | Owners drop to one of a group of equal stakeholders. Still advocate their financial interests but not to exclusion of other stakeholders.(4,4) | Managers are meta-stakeholders. They treat stakeholders and stakes equally and integrate these to the fullest extent possible.(4,5) | (4,6) |
| Stewardship Model(5,1) | Managers act as stewards for absentee owners; oversee the operations of corporation and exercise care over them. Emotion (care) plays an equal role with instrumental rationality.(5,2) | Desire and self interest are balanced out by social motives such as Rousseau's pity and Aristotle's virtues. (5,3) | Owners still set cardinal objectives but they also are responsible for providing managers with a meaningful work environment.(5,4) | Managers are stewards exercising care over the property of the owners in their absence. Stewardship is based on internally generated and self-imposed motives toward care.(5,5) | Value-based: (1) identify and formulate common standards of excellence, (2) develop training programs to foster pursuit of these excellences, and (3) develop support structures to help reduce value "gaps."(5,6) |

**Table 4.4** Summary of governance theory

**Activity 4.6**

1. Explain the difference between agency theory and stockholder theory?

2. Describe the similarities between agency theory and stewardship theory?

## The Board of Directors: Role and composition

### The board's responsibilities: The legal framework

The Malaysian Companies Act 1965 (MCA) provides for the statutory duties and liabilities of company directors. The common law principles on directors' duties further supplement the provisions of the MCA. Directors are considered as "officers" or "agents" of a company and have the capacity to enter into contracts on behalf of the company, subject to limitations on their authority to do so as imposed either by law, the company's articles of association or other legal instruments.

As with most jurisdictions, the business and affairs of a company are managed by the Board of Directors. The MCA prescribes a minimum of two directors, being natural persons of full age and both directors must reside primarily in Malaysia.

*Directors' general duties owed to the company*

**Statutory duties under the MCA**

The statutory duties of a director under the MCA include the following:

1. Duty to act in good faith and for proper purpose.

2. Discharge of the duty to exercise reasonable care and skill.

3. Reliance on information and advice.

4. Duty to ensure dividends declared from profit.

5. Duty to seek shareholders' approval.

6. Duty to keep proper accounts and registers.

## Common law duties of directors

As with most common law jurisdictions, Malaysia share similar common law duties imposed on directors, including but not limited to the following:

1. Non-fettering of director's discretion.
2. Prohibition from profiting secretly.
3. Duty of fidelity.

## Statutory restrictions and liabilities

In addition to the statutory directors' duties, there are various restrictions and liabilities imposed by the MCA on directors and these are as follows:

1. Conflicts of interests.
2. Duty to declare interests.
3. Restriction on participation by interested director.
4. Misuse of insider information or opportunities.
5. Restriction from taking loans.
6. Further duties of directors of public companies.
7. Statements in company prospectus.
8. False and misleading statements or reports.
9. Fraud and obtaining payment of money by false promise.

**Reading**

Please read Reading 4.2 entitled "Directors' duties and liabilities under Malaysian Law" by Wong & Partners. This article is available in WOU *MyDigital Library*'s E-course reserve.

## A board's role: A governance perspective

What does the phrase "direct the affairs of the company" really mean? To provide greater clarity, numerous individuals and organisations have developed more specific descriptions in recent years. One frequently cited description was developed by the Business Roundtable:

1. *First, the paramount duty of the board of directors of a public corporation is to select the Chief Executive Officer (CEO)* and to oversee the CEO and senior management in the competent and ethical operation of the corporation on a day-to-day basis.

2. *Second, it is the responsibility of management to operate the corporation in an effective and ethical manner to produce value for shareholders.* Senior management is expected to know how the corporation earns its income and what risks the corporation is undertaking in the course of carrying out its business. The CEO and board of directors should set a "tone at the top" that establishes a culture of legal compliance and integrity. Management and directors should never put personal interests ahead of or in conflict with the interests of the corporation.

3. *Third, it is the responsibility of management, under the oversight of the audit committee and the board, to produce financial statements that fairly present the financial condition and results of operations of the corporation and to make the timely disclosures investors need to assess the financial and business soundness and risks of* the corporation.

4. *Fourth, it is the responsibility of the board, through its audit committee, to engage an independent accounting firm to audit the financial statements prepared by management, issue an opinion that those statements are fairly stated in accordance with Generally Accepted Accounting Principles and oversee the corporation's relationship with the outside auditor.*

5. *Fifth, it is the responsibility of the board, through its corporate governance committee, to play a leadership role in shaping the corporate governance of the corporation.* The corporate governance committee also should select and recommend to the board qualified director candidates for election by the corporation's shareholders.

6. *Sixth, it is the responsibility of the board, through its compensation committee, to adopt and oversee the implementation of compensation policies, establish goals for performance-based compensation, and determine the compensation of the CEO and senior management.*

7. *Seventh, it is the responsibility of the board to respond appropriately to shareholders' concerns.*

8. Eighth, it is the responsibility of the corporation to deal with its employees, customers, suppliers and other constituencies in a fair and equitable manner.[1]

Milstein, Gregory, and Grapsas (2006) take a somewhat broader perspective. First, they note, *the board needs to take charge of its own focus, agenda, and information flow*. This enables a board to provide management with meaningful guidance and support. It also helps the board focus its attention appropriately, determine its own agenda, and obtain the information it needs to make objective judgements. Second, *the board must ensure that management not only performs but performs with integrity*. Selecting, monitoring and compensating management and, when necessary, replacing management, therefore continue to lie at the heart of board activity. Third, *the board must set expectations about the tone and culture of the company*. The standards of ethics and business conduct that are followed — or not followed — throughout a company impact the bottom line in many ways. "Tone at the top" should be a priority throughout the company and not viewed simply as a compliance matter. Fourth, *the board should work with management to formulate corporate strategy*. After agreeing to a strategic course with management through an iterative process, the board should determine the benchmarks that will evidence success or failure in achieving strategic objectives and then regularly monitor performance against those objectives. Fifth, *it is the board's duty to ensure that the corporate culture, the agreed strategy, management incentive compensation and the company's approach to audit and accounting, internal controls and disclosure are consistent and aligned*. And sixth, *it is the board's duty to help management understand the expectations of shareholders and regulators*. Boards can help management recognise that shareholders have a legitimate interest in more meaningful input into the board selection process, in terms of both nominating procedures and voting methods. Similarly, boards can help management recognise and address the concerns that excessive compensation raises among shareholders, regulators, rating agencies, and others.[2]

Both descriptions are useful for developing a basic understanding of a board's responsibilities. In broad terms, they fall into three categories: (a) to make decisions, (b) to monitor corporate activity, and (c) to advise management. The key issue here is deciding which board posture is appropriate at what time. While the law, corporate bylaws, and other documents frame many of the decisions a board must make, such as appointing a CEO or approving the financials, they do not provide much guidance with respect to the most important decision a board must make — when must board oversight become active intervention? For example, when should a board step in and remove the current CEO? When should directors veto a major capital appropriation or strategic move?

[1]Business Roundtable (2005), p. 2.

[2]Milstein, Holly, and Grapsas (2006, January).

Lists can never fully capture the complexity and intricacies of the governance function because they do not consider the specific challenges associated with different governance scenarios. In particular, the precise role of a board will vary depending on the nature of the company, industry, and competitive situation and the presence or absence of special circumstances, such as a hostile takeover bid or a corporate crisis, among other factors.

## The nature of the company, industry and competitive situation

It seems self-evident that a board's role depends largely on the nature and the strategic challenges of the company and the industry. The challenges faced by small, private, or closely held companies are not the same as those of larger, public corporations. In addition to their traditional fiduciary role, directors in small companies often are key advisers in strategic planning, raising, and allocating capital, human resources planning, and sometimes even performance appraisal. In large public corporations, directors are focused more on exercising oversight than on planning, on capital allocation and control rather than on the raising of capital, and on management development and succession activities rather than on broader human resources responsibilities.

Public company ownership patterns are not homogeneous either, and different ownership structures may call for different governance approaches. *The first, and most common, board situation is one in which a corporation has no controlling shareholder*. In that case, directors should behave as if there is a single absentee owner whose long-term interests they serve. A primary responsibility for the board in this scenario is to appoint and, if necessary, change management, just as an intelligent owner would do if he were present. Commenting on individual director's responsibilities in these circumstances, Buffett (1993) writes,

> *In this plain-vanilla case, a director who sees something he doesn't like should attempt to persuade the other directors of his views. If he is successful, the board will have the muscle to make the appropriate change. Suppose, though, that the unhappy director can't get other directors to agree with him. He should then feel free to make his views known to the absentee owners. Directors seldom do that, of course. The temperament of many directors would in fact be incompatible with critical behaviour of that sort. But I see nothing improper in such actions, assuming the issues are serious. Naturally, the complaining director can expect a vigorous rebuttal from the unpersuaded directors, a prospect that should discourage the dissenter from pursuing trivial or non-rational causes.*[3]

*The second situation occurs when the controlling owner is also the manager.* At some companies, such as Google, this arrangement is facilitated by the existence of two classes of stock endowed with disproportionate voting power. In these situations, the board does not act as an agent between owners and management, and directors cannot affect change except through persuasion. Therefore, if the owner or manager

[3]Buffett, annual letter to Berkshire Hathaway shareholders (1993).

is mediocre — or worse, is overreaching — there is little a director can do about it except object. And if there is no change and the matter is sufficiently serious, the outside directors should resign. Their resignation will signal their doubts about management, and it will emphasise that no outsider is in a position to correct the owner or manager's shortcomings.[4]

*The third public corporation governance situation occurs when there is a controlling owner who is not involved in management*. This case, examples of which are Hershey Foods and Dow Jones, puts the outside directors in a potentially value-creating position. If they become unhappy with either the competence or integrity of the manager, they can go directly to the owner (who may also be on the board) and make their views known. This situation helps an outside director, since he need make his case only to a single, presumably interested owner who can immediately make a change if the argument is persuasive. Even so, the dissatisfied director has only that single course of action. If he remains unsatisfied about a critical matter, he has no choice but to resign.[5]

It will also be readily apparent that the role of the board will vary depending on the size of the company, the industries it serves, and the competitive challenges it faces. Global corporations face different challenges from domestic ones; the issues in regulated industries are different from those in technology or service industries, and high growth scenarios make different demands on boards than more mature ones. Finally, in times of turbulence or rapid change in the industry, boards often are called on to play a more active, strategic role than in calmer times. Special events or opportunities, such as takeovers, mergers, and acquisitions, fall into this category.

## The presence or absence of special circumstances such as a hostile takeover bid or a corporate crisis

Company crises can take on many different forms — defective products, hostile takeovers, executive misconduct, natural disasters that threaten operations, and many more. But, as boards know very well, they all have one thing in common: They threaten the stock price and sometimes the continued existence of the company. Some examples follow:

1. In June 2008, with encouragement from federal regulators, JP Morgan executed a takeover bid for Wall Street giant Bear Stearns to prevent the bank's collapse as a consequence of the U.S. mortgage debt crisis. The $240 million acquisition price represented a substantial discount on its share price at the end of trading the week before, which valued the bank at around $3.5 billion.

2. In 2002, when allegations of insider trading against Martha Stewart were reported, the stock price of Martha Stewart Omnimedia fell some 40% in just 3 weeks.

[4]Buffett (1993).

[5]Buffett (1993).

3. In 1993, an allegation of E. coli contamination in the beef served by the Jack in the Box hamburger chain caused the company's share price to plummet from $14 to about $3 in a matter of hours.

4. In 1985, A. H. Robins, the maker of the Dalkon Shield, an intrauterine device, was forced to declare bankruptcy, after collapsing under a wave of personal injury lawsuits.

5. As these examples attest, there are few situations in which directors' fiduciary duties to shareholders are so clearly on view as in times of crisis.[6]

## The board's role: Governance, not management

Beyond implementing reforms and best practices, boards are being counseled to become more involved.[7] Rubber-stamping decisions, populating boards with friends of the CEO, and convening board meetings on the golf course are out; engagement, transparency, independence, knowing the company inside and out, and adding value are in. This all sounds good. There is a real danger, however, that the rise in shareholder activism, the new regulatory environment, and related social factors are pushing boards toward micromanagement and meddling.

This issue is troubling, and clear evidence that the important differences that separate *governance from management* — critical to effective governance — are still not sufficiently well understood by directors, executives, regulators, and the popular press alike. And regrettably, faced with the need to be more involved, the most obvious opportunity (and danger) is for boards to expand their involvement into — or, more accurately, intrude into — management's territory.

The key issues are how and to whom boards add value.[8] Specifically, the potential of directors to add value is all too often framed in terms of their ability to add value to management by giving advice on issues such as strategy, choice of markets, and other factors of corporate success. While this may be valuable, *it obscures the primary role of the board to govern, the purpose of which is to add value to shareholders and other stakeholders*. John Carver, well-known governance consultant and author, does not mince words:

> *Governance is an extension of ownership, not of operations. Directors must be more allied with shareholders than with managers. Their mentality, their language, their concerns, their skills, their choice of interactions are subsets of ownership, not of management. As long as we view governance as übermanagement — focusing on management methods, strategies and planning — finding a new balance between micromanagement and detachment… will be hard to come by.*[9]

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[6]Jones (2007).

[7]See, for example, Felton and Pamela Fritz (2005); and The State of the Corporate Board, 2007 — A McKinsey Global Survey (2007, April).

[8]Carver (2007, November), pp. 1030 – 1037.

[9]Carver (2007, November), p. 1035.

A greater arms-length relationship between management and the board, therefore, is both desirable and unavoidable. Recent governance reforms focused on creating greater independence and minimising managerial excess while enhancing executive accountability have already created greater tension in the relationship between management and the board. The Sarbanes-Oxley Act, for example, effectively asks boards to substitute verification for trust. Section 404 of the act requires management at all levels to "sign off" on key financial statements.

This is not necessarily bad because trust and verification are not necessarily incompatible. In fact, we need both. But we should also realise that effective governance is about striking a reasonable accommodation between verification and trust — not about elevating one over the other. The history of human nature shows that adversarial relationships can create their own pathologies of miscommunication and mismanaged expectations with respect to risk and reward. This makes defining the trade-offs that shape effective governance so difficult. Is better governance defined primarily by the active prevention of abuse? Or by the active promotion of risk taking and profitability? The quick and easy answer is that it should mean all of those things. However, as recurrent crises in corporate governance around the world have shown, it is hard to do even one of those things consistently well. What is more, a board trying to do all of these things well is not merely an active board; it is a board actively running the company. This is not overseeing management or holding management accountable — it is management. Therefore, the corporate governance reform agenda risks becoming an initiative that effectively dissolves most of the critical, traditional distinctions between the chief executive and the board.[10]

## Governance guidelines

As part of the recent wave of governance reforms, the NYSE adopted new rules that require companies to adopt and publicly disclose their corporate governance policies. Specifically, the following subjects must be addressed in the guidelines:

1. *Director qualification standards*. These standards, in addition to requiring independence, may also address other substantive qualification requirements, including policies limiting the number of boards on which a director may sit and director tenure, retirement, and succession.

2. *Director responsibilities*. These responsibilities should clearly articulate what is expected from a director, including basic duties and responsibilities with respect to attendance at board meetings and advance review of meeting materials.

3. *Director access to management and, as necessary and appropriate, to an independent advisor*. Clear policies should be adopted that define protocols for director access to corporate managers and identify situations when the board should retain external advisors.

[10]Macavoy and Milstein (2003).

4. *Director compensation*. Director compensation guidelines should include general principles for determining the form and amount of director compensation (and for reviewing those principles, as appropriate).

5. *Director orientation and continuing education*. Director orientation and continuing education should be the responsibility of the governance committee, if one exists. If the board does not have a separate governance committee, the full board, the nominating committee, or both, should have this responsibility.

6. *Management succession*. Succession planning should include policies and principles for CEO selection and performance review, as well as policies regarding succession in the event of an emergency or the retirement of the CEO.

7. *Annual performance evaluation of the board*. The board should conduct a self-evaluation at least annually to determine whether it and its committees and their individual directors are functioning effectively.

Best practice suggests that the board should review the guidelines at least annually. By elaborating on the board's and directors' basic duties, a carefully constructed set of governance guidelines will help both the board and individual directors understand their obligations and the general boundaries within which they will operate.

## Recent board trends

### *Board size*

The optimal size of a board has been the subject of much debate in recent years. As a general proposition, smaller boards have a number of advantages over larger ones. They are easier to convene, require less effort to lead, and often have a more relaxed, informal culture. Research on group decision making supports the contention that smaller groups typically are more effective.[11]

As a practical matter, however, board size should be governed by the skills needed to do the job. Larger corporations with more complex structures, substantial global interests, or multi business operations will require larger boards than smaller, mainly domestic, single-business firms. Today, the average *Standard & Poor's 500* board has 11 directors, compared to 18 directors about 25 years ago. It is unlikely boards will shrink further, however, as a result of new rules and proposals requiring that the audit, nominating or governance, and compensation committees of boards in publicly held companies be composed of independent directors only, in some cases, with specialised expertise (audit committee).

[11]The statistics in this chapter are taken from the Spencer Stuart Board Index 2007.

## Board membership

Fewer CEOs are accepting directorships, for two reasons. First, many boards — in the wake of the recent scandals and the Sarbanes-Oxley legislation — now insist that the chief executive concentrate fully on his or her job and restrict the number of outside boards the CEO can serve or, in some cases, prohibit it altogether. Second, as boards expand their role to areas, such as company strategy, they look for directors who have risen through specific functional areas in which the company must excel in order to compete effectively — sales and marketing, global operations, manufacturing, and others. And, in the aftermath of Sarbanes-Oxley, directors with a background in finance, especially chief financial officers (CFOs), are in strong demand.[12]

For a while, it looked as though the reduced availability of CEOs and the growing demand for specialised directors would significantly reduce the talent pool of qualified directors and make it even more difficult for companies to attract new board members. Fortunately, this has not proven to be the case. If anything, the talent pool has become larger as boards are changing the definition of what constitutes a qualified candidate and widening their search. Instead of focusing almost exclusively on CEOs as candidates for the board, companies are increasingly tapping division presidents and other executives who have experience running large operations or bring specialist expertise. The redefinition of director qualifications has also expanded the talent pool of diversity candidates who may not have risen to chief executive but excel in a critical, functional area.

These changes do not mean that attracting qualified directors has become easier. Although the pool of qualified candidates is larger, many candidates are far more reluctant to serve. More than ever, candidates perform extensive due diligence about the companies recruiting them and look for ways to mitigate as much as possible the risk of associating themselves with a disaster or incurring personal liability. They are also far more critical and objective about their ability to add value, particularly in complex organisations, such as conglomerates, or industries like financial services and insurance. The overwhelming reason why candidates decline to serve, however, remains a lack of time. Given their already enormous responsibilities, many qualified and desirable director candidates feel that they will be unable to devote adequate attention to the job.

## Director independence

The proposition that boards should "act independently of management, through a thoughtful and diligent decision-making process," has been a major focus of corporate governance reform in recent years.[13] In the United States, the Sarbanes-Oxley Act of 2002, as well as the revised NYSE and NASDAQ listing rules, as affirmed by the SEC, are premised on a belief that director independence is essential to effective corporate governance. In the United Kingdom, the Cadbury Commission's report

[12]Heidrick and Struggles (2006).

[13]Macavoy and Milstein (2003), pp. 22 – 23.

of 1990 — *The Code of Best Practice* — included *a recommendation for having at least three nonexecutive directors on the board*. Currently, reflecting this broad consensus, about 10 out of the average 12 directors of a major U.S. public company board are nonexecutives; in the United Kingdom, the corresponding number is a little less than half.

The idea of an independent board is intuitively appealing. Director independence, defined as the absence of any conflicts of interest through personal or professional ties with the corporation or its management, suggests objectivity and a capacity to be impartial and decisive and therefore a stronger fiduciary. At times a board needs to discuss issues that involve some or all of the company's senior executives; this is difficult to do with senior executives on the board. The independence requirement also stops destructive practices, such as "rewarding" former CEOs for their accomplishments by giving them a role on the board. Having the former CEO on the board almost always limits the ability of the new CEO to develop his or her own relationship with the board and put his or her imprint on the organisation. There is also limited evidence that outsider-dominated boards are more proactive in firing underperforming CEOs and less willing to go along with outsized compensation proposals or vote for poison pills.

Director independence should not be viewed as a proxy for good governance, however. At times, not having more insiders on the board actually can reduce a board's effectiveness as an oversight body or as counsel to the CEO. Independent, nonexecutive directors can never be as knowledgeable about a company's business as executive directors or senior managers. CEOs say that some of their most valuable directors are those with experience in the same industry, counter to current independence tests. The higher the proportion of outside directors, therefore, the more difficult it is to foster high-quality, deep board deliberations. Moreover, it is less likely that a CEO can mislead a board, intentionally or otherwise, when some of the directors are insiders who also have intimate knowledge of the company.[14] Boards mostly comprised of independent directors must, at a minimum, therefore, create regular opportunities to interact with senior executives other than the CEO. The more complex a company's business is, the more important such communications are.

The bottom line is that effective corporate governance does not depend on the independence of some particular subset of directors but on the independent behaviour of the board as a whole. The focus should be on fostering board independence as a behavioural norm, a psychological quality, rather than on quasi-legal definitions of director independence. Director independence can contribute to but is no guarantee for better governance.

[14]Carter and Lorsch (2004), p. 93.

## Board leadership: Should we separate the chairman and CEO positions?

Few issues in corporate governance are as contentious as the question of whether the roles of chairman and CEO should be separated or combined. In the United Kingdom, about 95% of all Financial Times Stock Exchange (FTSE) 350 companies adhere to the principle that different people should hold each of these roles. In the United States, by contrast, most companies still combine them, although the idea of splitting the two roles is gaining momentum. In the last 2 years, Boeing, Dell, the Walt Disney Company, MCI, Oracle, and Tenet Healthcare all have done so, and a new study finds that roughly one third of U.S. companies have adopted such a split-leadership structure, up from a historical level of about one fifth.[15]

Arguments for splitting the two roles, emanating chiefly from the United Kingdom — and other countries that overwhelmingly embrace the idea of separate roles (particularly Germany, the Netherlands, South Africa, Australia, and, to a lesser extent, Canada) — reflect four schools of thought.[16]

*The first is that the separation of the chairman and CEO positions is a key component of board independence because of the fundamental differences and potential conflicts between these roles*. The CEO runs the company — the argument goes — and the chairman runs the board, one of whose responsibilities it is to monitor the CEO. If the chairman and the CEO are one and the same, it is hard for the board to criticise the CEO or to express independent opinions. A separate chairman, responsible for setting the board's agenda, is more likely to probe and encourage debate at board meetings. Separating the two roles is, therefore, essentially a check on the CEO's power.

*A second argument is that a non-executive chairman can serve as a valuable sounding board, mentor, and advocate to the CEO*. Proponents of this view note that CEOs today face enough challenges without having to run the board and that a relationship with the chairman based on mutual trust and regular contact is good for the CEO, shareholders, and the company. For this to happen, however, it is essential that, from the outset, the two roles be clearly defined to avoid territorial disputes or misunderstandings.

*A third reason for supporting the two-role model is that a non-executive chairman is ideally placed to assess the CEO's performance, taking into account the views of fellow board directors*. Advocates maintain that the presence of a separate, independent chairman can help maintain a longer term perspective and reduce the risk that the CEO will focus too much on shorter term goals, especially when there are powerful incentives and rewards to do so. They add that he is also in a good position to play a helpful role in succession planning. And when a CEO departs, voluntarily or otherwise, the chairman's continued presence in charge of the board can reduce the level of trauma in the business and the investor community.

[15]This finding is reported in a September 2004 study of more than 2,500 companies across the world by Governance Metrics International, the New York–based corporate governance ratings agency.

[16]Coombes and Wong (2004).

*A fourth and final argument concerns the time needed to do both jobs and do them well.* It can be argued that as companies grow more complex, a strong board is more vital than ever to the health of the company, and this requires a skilled chairman who is not distracted by the daily pull of the business and can devote the required time and energy. This may take one or more days per week and involve such tasks as maintaining contact with directors between meetings, organising board evaluations, listening to shareholder concerns, acting as an ambassador for the company, and liaising with regulators, thereby allowing the CEO to concentrate on running the business.

Although these arguments increasingly resonate with U.S. directors and shareholders, many CEOs resist the change. Why, they ask, should corporate wrongdoing at a small number of S&P 500 companies be a compelling reason for changing a system that has worked well for so long? Moral and ethical failures are part of the human condition, they note, and no rules or regulations can guarantee the honesty of a leader. Some allow that, at times, a temporary split in roles may be desirable or necessary — when a company is experiencing a crisis, for example, or when a new CEO is appointed who lacks governance and boardroom experience. But they maintain that such instances are infrequent and temporary and do not justify sweeping change. Overall, they argue, the combined model has served the U.S. economy well, and splitting the roles might set up two power centers, which would impair decision making.

Critics of the split-role model also point out that finding the right chairman is difficult and that what works in the United Kingdom does not necessarily work in the United States. Executives in the United Kingdom tend to retire earlier and tend to view the nonexecutive chairman role (often a 6-year commitment) as the pinnacle of a business career. This is not the case in the United States, where the normal retirement age is higher.

To allay concerns that combined leadership compromises a board's independence, opponents of separation have proposed the idea of a "lead director": a non-executive who acts as a link between the chairman — CEO and the outside directors, consults with the chairman — CEO on the agenda of board meetings and performs other independence-enhancing functions. Some 30% of the largest U.S. companies have taken this approach. Its defenders claim that — combined with other measures, such as requiring a majority of independent directors and board meetings without the presence of management — this alternative obviates the need for a separate chairman. On balance, the arguments for separating the roles of chairman and CEO are persuasive because separation gives boards a structural basis for acting independently. And reducing the power of the CEO in the process may not be bad; compared with other leading Western economies, the United States concentrates corporate authority in a single person to an unusual extent.[17] Furthermore, rather than create confusion about accountability, the separation of roles makes it clear that the board's principal function is to govern — that is, to oversee the company's management, and hence to protect the shareholders' interests — while the CEO's function is to manage the company well.

[17]Coombes and Wong (2004).

Separating the two roles, of course, is no guarantee for board effectiveness. A structurally independent board will not necessarily exercise that independence: Some companies with a separate chairman and CEO have failed miserably in carrying out their oversight functions. What is more, a chairman without a strong commitment to the job can stand in the way of board effectiveness. The separation of roles must therefore be complemented by the right boardroom culture and by a sound process for selecting the chairman. The challenge of finding the right non-executive chairman who must not only have the experience, personality, and leadership skills to mesh with the current board and management but also must show that the board is not a rubber stamp for the CEO, should not be underestimated. The ideal candidate must have enough time to devote to the job, strong interpersonal skills, a working knowledge of the industry, and a willingness to play a behind-the-scenes role. The best candidate is often an independent director who has served on the board for several years.

## Board committees and director compensation

A greater and more effective use of committees also stands out as one of the key changes in board functioning over the last 50 years. Committees permit the board to divide up its work among the directors; they also allow board members to develop specialised knowledge about specific issues. The value of having standing committees has been recognised by the NYSE, the NASDAQ, and the Securities and Exchange Commission (SEC), and today public company boards are required to have independent *audit, nominating (and governance), and compensation committees*. In addition, a growing number of companies are creating board committees to better communicate with and stay abreast of the concerns of external stakeholders, referred to as *public responsibility, corporate social responsibility, stakeholder relations*, or *external affairs committees*.

## The audit committee

The audit committee is charged with assisting the board in its oversight of:

1. the integrity of the company's financial statements and internal controls;

2. compliance with legal and regulatory requirements, as well as the company's ethical standards and policies;

3. the qualifications and independence of the company's independent auditor and the performance of the company's internal audit function and its independent auditors; and

4. preparing the audit committee report for inclusion in the company's annual proxy statement.

The committee typically consists of no fewer than three members, all of whom must meet the independence and experience requirements of the NYSE and rule 10A-3 under the Securities Exchange Act of 1934, which hold that each member of the Committee must be financially "literate" and at least one member of the committee must have accounting or related financial management expertise (the so-called audit committee financial expert). Its members, including the committee chair, usually are appointed by the board on the recommendation of the nominating and governance committee.

## The nominating (and governance) committee

The nominating (and governance) committee has multi facetted responsibilities and is typically charged with recommending new candidates for the board of directors and determining:

1. the eligibility of proposed candidates;
2. reviewing the company's governance principles and practices;
3. establishing and overseeing self-assessment by the board;
4. recommending director compensation; and
5. implementing succession planning for the CEO.

The nominating (and governance) committee normally consists of three or more independent directors; its members and chair are usually appointed by the board on the recommendation of the chairman of the board.

## The compensation committee

The compensation committee is charged with duties related to human resources policies and procedures, employee benefit plans, and compensation. It is also responsible for preparing a report on executive compensation for inclusion in the company's annual proxy statement. It typically consists of three or more independent members; its members are normally appointed by the board on the recommendation of the chairman of the board with the concurrence of the nominating (and governance) committee.

## Other board committees

In addition to these standing committees, a growing number of companies make use of ad hoc committees to address specific issues — a strategy committee to look at different growth options, for example, or a finance committee to develop recommendations to recapitalise the company. While ad hoc committees can be useful, they should have clear sunset clauses to prevent their institutionalisation or a balkanisation of the board on important issues.

Committees can also be used to send specific signals to employees or external stakeholders about what is important to the company. A growing number of boards are creating committees to better communicate with and stay abreast of the concerns of external stakeholders. Names for such committees include the *corporate social responsibility, stakeholder relations, external affairs, or public responsibilities committees*. For example, the board of General Electric has created a public responsibilities committee to review and oversee the company's positions on corporate social responsibilities and public issues of significance that affect investors and other GE key stakeholders.

Finally, most bylaws make provision for an executive committee, usually consisting of the chair, the CEO and other designated officers of the company, and key directors, such as the chairs of the standing committees. In theory, the executive committee has the power to act for the full board in case of emergencies or when there is no time for the full board to meet and deliberate, although this is fraught with danger. Fortunately, advances in communication technology have made executive committees increasingly redundant, and their use has all but disappeared from the corporate governance landscape.

## Director compensation

Setting director pay typically is not done by the compensation committee of the board. Rather, director pay decisions normally are made by the nominating committee. The justification for this structure is twofold. *First, it provides for a separation of the director and executive compensation decisions. Second, it allows the nominating committee to integrate compensation with board-building strategies*.

The job of director has become significantly more challenging in recent years; it demands stronger qualifications, requires more time, and increasingly carries personal financial risk. In this new governance climate, the pool of available independent directors has shrunk and pushed up director pay. Directors are typically paid with a mix of cash and equity, with equity representing about half of the total direct compensation. Non-employee chair and lead-director pay is generally structured like that of other directors on the board (retainer, meeting fees, and equity), while employee, non-CEO chairs are typically paid like an employee (salary, incentives, and benefits). A majority of companies pay a premium to committee chairs — especially audit and compensation committee chairs — reflecting the increased time commitment and additional responsibility. With respect to the equity component of director compensation, companies have reduced their reliance on stock options and increased the use of full-value awards.

## Activity 4.7

1. What are the individual director's duties and responsibilities as recommended by the Malaysian Company Law Act 1965?

2. What are the roles of the Board of Directors?

## Summary

Corporate governance is the system of rules, practices and processes by which a company is directed and controlled. Corporate governance essentially involves balancing the interests of the many stakeholders in a company — these include its shareholders, management, customers, suppliers, financiers, government and the community. Since corporate governance also provides the framework for attaining a company's objectives, it encompasses practically every sphere of management, from action plans and internal controls to performance measurement and corporate disclosure.

The Corporate Governance Guidelines are established by the Board of Directors of a corporation to provide a structure within which the directors and management will effectively pursue the corporation's objectives for the benefit of its stockholders. The Board intends that the guidelines serve as a flexible framework within which the Board may conduct its business, not as a set of binding legal obligations. These guidelines should be interpreted in the context of all applicable laws, any charter documents and other governing legal documents and the company's policies.

## Self-test 4.2

1. How is stakeholder theory relevant to corporate governance?

2. Board leadership: Should there be a separate Chairman and CEO positions?

## Suggested answers to activity

**Feedback**

**Activity 4.7**

1. A director should:

   a. Duty to act in good faith and for proper purpose.

   b. Discharge of the duty to exercise reasonable care and skill.

   c. Reliance on information and advice.

   d. Duty to ensure dividends declared from profit.

   e. Duty to seek shareholders' approval.

   f. Duty to keep proper accounts and registers.

2. a. To select the Chief Executive Officer (CEO) and to oversee the CEO and senior management in the operations of the corporation on a day-to-day basis.

   b. To set the "tone" of the company that establishes a culture of legal compliance and integrity.

   c. Through its management, to produce financial statements that fair present the financial condition of the corporation.

   d. Through its audit, to engage an independent accounting firm to audit the financial statements prepared by management.

   e. Through the governance committee, to play a leadership role in shaping corporate governance of the corporation.

   f. Through the compensation committee, to adopt and oversee the implementation of compensation policies, establish goals for performance based compensation, and determine the compensation of CEO and senior management.

   g. To respond appropriately to shareholder's concern.

   h. To ensure that the corporation deals with its employees, customers, suppliers and other constituencies in a fair and equitable manner.

# 4.3 Code of Ethics

## Objectives

By the end of this section, you should be able to:

1. Define code of ethics.
2. Distinguish the uses and purpose of the code.
3. Examine the development of statement of values.
4. Describe the objections to the code of ethics.

## Introduction

Codes of ethics evoke opposite reactions from people who teach, do research in, or are practitioners of occupational and professional ethics. Some hold that teaching codes of ethics is essential to prepare students for their future careers. Corporations, for example, have come to view codes as the cornerstone of a successful compliance programme. Professional societies such as the Puerto Rico State Society of Professional Engineers and Land Surveyors, also make the drafting, revising and disseminating professional codes of ethics a central part of practicing professional engineering ethics. But many strongly oppose codes because they promote the wrong sorts of attitudes in those who would be influenced by them. As you will see below, philosophical ethicists raise objections to codes because they undermine moral autonomy, lead to uncritical acceptance of authority, and replace moral motives with fear of punishment. These polar stances are grounded in the very different perspectives from which different groups approach codes. But they are also grounded in the fact that codes take many different forms and serve distinct functions. For example, consider the introductory considerations presented in the following.

## Different uses for codes

### Kinds of codes

1. **Professional codes of ethics**. Professions such as engineering and accounting have developed codes of ethics. These set forth the ideals of the profession as well as more mundane challenges faced by members. Engineering codes, for example, set forth service to humanity as an ideal of the profession. But they also provide detailed provisions to help members recognise conflicts of interest, issues of collegiality, and confidentiality responsibilities. The following is a list of code of ethics from various professions:

a. American Marketing Association Code of Ethics
http://web.csulb.edu/colleges/cba/marketing/code-of-ethics/

b. ACCA code of ethics and conduct
http://www.accaglobal.com/sg/en/member/professional-standards/ethics/code-ethics-conduct.html

c. CIMA code of ethics
http://www.cimaglobal.com/Professional-ethics/Ethics/CIMA-code-of-ethics-for-professional-accountants/

d. American Institute of Architects
http://www.aia.org/about/ethicsandbylaws/

e. The Malaysian Business Code of Ethics by Ministry of Domestic Trade, Co-operatives and Consumerism
http://www.kpdnkk.gov.my/kpdnkkv3/index.php?option=com_content&view=article&id=218&Itemid=304&lang=en

f. Code of Ethics for Company Directors by Companies Commission of Malaysia
https://www.ssm.com.my/en/code-ethics-company-directors

g. Code of Ethics for Company Secretaries by Companies Commission of Malaysia
http://www.ssm.com.my/en/code-ethics-company-secretaries

2. **Corporate codes of ethics**. Corporate codes are adopted by many companies. These codes provide guidelines on particularly sticky issues (When does a gift become a bribe?) They also set forth provisions that express the core values of the corporation. These lengthy codes with detailed provisions support a compliance approach to organisational discipline.

a. Intel code of conduct
http://www.intel.com/content/www/us/en/policy/policy-code-conduct-corporate-information.html

b. Google code of conduct
https://investor.google.com/corporate/code-of-conduct.html

c. Samsung Electronics code of conduct
http://sec-audit.com/eng/main.asp

3. **Corporate credos**. Some companies have shortened their lengthy codes into a few general provisions that form a creed. Johnson and Johnson's Credo is famous in this respect and can be found by clicking on the link provided below.

   a. Johnson and Johnson's Credo
      http://www.jnj.com/about-jnj/jnj-credo

   b. Verizon
      http://www.verizon.com/about/our-company/our-culture

4. **Statements of values**. Finally, more mature companies find it useful to express and disseminate their core value commitments in statements of values. These form the basis of values-based decision-making. While codes of ethics clearly establish minimum standards of acceptable conduct, statements of values outline the aspirations that can drive companies toward continuous improvement.

   a. University of Missouri
      http://missouri.edu/about/statement-of-values.php

   b. Barclays
      http://www.barclays.com/about-barclays/barclays-values.html

   c. The Sime Darby Group
      http://www.simedarby.com/Core_Values.aspx

## Functions or purposes served by codes

1. **Discipline**. This function gets all the attention. Most codes are set forth to establish clearly and forcefully an organisation's standards, especially its minimum standards of acceptable conduct. Having established the limits, organisations can then punish those who exceed them.

2. **Educate**. This can range from disseminating standards to enlightening members. Company A's employees learnt that anything over $100 was a bribe and should not be accepted. But engineers learn that their fundamental responsibility is to hold paramount public safety, health, and welfare. Codes certainly teach minimum standards of conduct, but they can help a community to articulate and understand their highest shared values and aspirations.

3. **Inspire**. Codes can set forth ideals in a way that inspires a community's members to strive for excellence. They can be written to set forth the aspirations and value commitments that express a community's ideals. They can point a community toward moral excellence.

4. **Stimulate dialogue**. Engineering professional codes of ethics have changed greatly over the last 150 years. This has been brought about by a vigorous internal debate stimulated by these very codes. Members debate controversial

claims and work to refine more basic statements. Johnson and Johnson credits their credo for their proactive and successful response to the Tylenol crisis. Regularly, employees "challenge the credo" by bringing up difficult cases and testing how effectively the credo guides decision making and problem solving. The CIAPR's Disciplinary Tribunal cases have served as a focus for discussions on how to interpret key provisions of the organisation's code of ethics. The NSPE Board of Ethical Review decisions have also provided an excellent forum for clarifying ethical concepts (public safety, conflict of interest) in the context of cases brought to the board by NSPE members. The BER discusses cases in terms of relevant provisions of the NSPE code. Over the years, the NSPE BER has established a firm foundation for the resolution of difficult ethical cases by developing analogies with cases it has already discussed and clarified.

5. **Empower and protect**. Codes empower and protect those who are committed to doing the right thing. If an employer orders an employee to do something that violates that employee's ethical or professional standards, the code provides a basis for saying, "No!". Engineers have refused to carry out directives that place in jeopardy the health and safety of the public based on statements like canon 1 of the CIAPR code. (The NSPE code has similar provisions.) Because codes establish and disseminate moral standards, they can provide the structure to convert personal opinion into reasoned professional judgement. To reiterate, they provide support to those who would do the right thing, even under when there is considerable pressure to do the opposite.

6. **Codes capture or express a community's identity**. They provide the occasion to identify, foster commitment, and disseminate the values with which an organisation wants to be identified publicly. These values enter into an organisation's core beliefs and commitments forming an identify-conferring system. By studying the values embedded in a company's code of ethics, observing the values actually displayed in the company's conduct, and looking for inconsistencies, the observer can gain insight into the core commitments of that company. Codes express values that, in turn, reveal a company's core commitments, or (in the case of a hypocritical organisation) those values that have fallen to the wayside as the company has turned to other value pursuits.

## Difficulties with codes

The following objections lead philosophers to argue that presenting codes of ethics in ethics classes undermines several key moral attitudes and practices.

1. *Codes can undermine moral autonomy by habituating us to act from motives like deference to external authority and fear of punishment*. We get out of the habit of making decisions for ourselves and fall into the habit of deferring to outside authority.

2. *Codes often fail to guide us through complex situations*. Inevitably, gaps arise between general rules and the specific situations to which they are applied; concrete situations often present new and unexpected challenges that rules, because of their generality, cannot anticipate. Arguing that codes should provide action recipes for all situations neglects the fact that effective moral action requires more than just blind obedience to rules.

3. *Codes of ethics can encourage a legalistic attitude that turns us away from the pursuit of moral excellence and toward just getting by or staying out of trouble*. For example, compliance codes habituate us to striving only to maintain minimum standards of conduct. They fail to motivate and direct action toward aspirations. Relying exclusively on compliance codes conveys the idea that morality is nothing but staying above the moral minimum.

**Activity 4.8**

1. What are the functions served by the codes?

2. What are some of the difficulties with codes?

## Statement of values

This section is designed to steer you through these complex issues by having you draft a *statement of values* for students at your university. As you work through your statement of values, you will learn that codes have strengths and weaknesses, serve different functions, and embody values.

A faculty group set out to construct a code of ethics in order to respond to accreditation requirements. They began with the idea of constructing a stakeholder code.

1. First, they identified the stakeholders of the college's activities, that is, groups or individuals who had a vital interest in that community's actions, decisions and policies.

2. Second, they identified the goods held by each of these stakeholders which could be vitally impacted by the actions of the college. For example, education represented the key good held by students that could be vitally impacted by the activities and decisions of the College.

3. Working from each stakeholder relation and the good that characterised that relation, members of the college began crafting code provisions. Some set forth faculty duties such as keeping regular office hours, grading fairly, and keeping up to date in teaching and research. Others emphasised student duties such as working responsibly and effectively in work teams, adhering to standards of academic honesty, and attending classes regularly.

Because stakeholder codes embody a community's values, the individuals in charge of drafting the code decided that a more direct approach would be to identify the embodied values and refine them into a statement of values. This formal statement could later be developed in different directions including a more detailed compliance code.

## Compliance oriented codes and programmes versus values oriented codes and programmes

### *Compliance strategy*

The initial and still probably the most prevalent method for responding to the Federal Sentencing Guidelines is the compliance strategy. This strategy is based on three interrelated components:

1. **Rules**: Compliance strategies are centered around strict codes of ethics composed of rules that set forth minimum thresholds of acceptable behaviour. The use of rules to structure employee action does run into problems due to the gap between rule and application, the appearance of novel situations, and the impression that it gives to employees that obedience is based on conformity to authority.

2. **Monitoring**: The second component consists of monitoring activities designed to ensure that employees are conforming to rules and to identify instances of non-compliance. Monitoring is certainly effective but it requires that the organisation expend time, money, and energy. Monitoring also places stress upon employees in that they are aware of constantly being watched. Those under observation tend either to rebel or to automatically adopt behaviours they believe those doing the monitoring want. This considerably dampens creativity, legitimate criticism, and innovation.

3. **Disciplining misconduct**: The last key component to a compliance strategy is punishment. Punishment can be effective especially when establishing and enforcing conduct that remains above the criminal level. But reliance on punishment for control tends to impose solidarity on an organisation rather than elicit it. Employees conform because they fear sanction. Organisations based on this fear are never really free to pursue excellence.

## Values orientation

To facilitate comparison, three correlative but different elements to values-based or aspirational approaches will be identified.

1. **Development of shared values**: Using a process similar to the one described above, a company develops a statement of shared values. These provide guidelines that replace the hard and fast rules of a compliance code. Statements in values-oriented codes play a different logical function than statements

in compliance codes. "Principles of Professional/Organisational Conduct" in compliance codes specify circumstances of compliance: time, agent, place, purpose, manner, etc. These provide sufficient content to set forth principles of professional conduct as rules that can be violated. This, in turn, allows them to be backed by punishment for violation. "Ideals of the Profession" (or organisation) set forth a community's shared aspirations. These are pitched at a level well above and beyond the minimum. Communities can and should define themselves as much by their aspirations as by their threshold standards.

2. **Support for employees**: Since statements of values set forth excellences or aspirations, the role of the organisation changes from monitoring and then punishing misbehaviour to finding ways of opening avenues for employees to realise key values in their day-to-day activity. Excellence is not something to be reached overnight. It requires rethinking basic motivations, attitudes, beliefs, and goals. Companies need to identify obstacles to achieving ideals and then develop support structures to help those who seek to realise ideals. Values-based approaches change from punishing conduct that falls below the minimum to providing collective support to those who strive for the excellent.

3. **Locking in on continual improvement**: The philosopher, John Dewey, characterises moral responsibility as the drive to better ourselves. The particular twist in Dewey's approach is to find ways of folding what has been learnt from the past into meeting new challenges that arise in the future. This involves changing habits and, ultimately, changing character. Continual improvement is the ultimate goal of corporations oriented toward excellence. The values these "moral ecologies" identify structure and channel this endeavour. What is needed at this stage is to develop concrete programs and strategies for identifying obstacles to excellence, removing them, and remaining on track for excellence.

   To summarise, some companies identify a compliance strategy where they set forth rules that establish minimum levels of acceptable conduct, monitor compliance, and punish non-compliance. Others, value-oriented or aspiration-oriented companies, identify core values or aspirations (by reflecting on community values and finding them embedded in extant codes of ethics), develop programmes and structures to support those who strive for these values, and work to lock in a programme of continual improvement or betterment.

4. **Something to think about**. Compliance approaches work best in what of company, organisation or moral ecology. (Think about this in terms of the central or core commitments such as those in finance-, customer-, and quality-driven companies.) Values-based approaches work best in what kind of company, organisation or moral ecology? How does one transition from compliance to values-based approaches? How does one integrate the two?

# Objections to and mischievous side effects of codes of ethics

## Objections to code of ethics

These objections are taken from John Ladd, 'The Quest for a Code of Professional Ethics: An Intellectual and Moral Confusion'. This article can be found in Deborah G. Johnson, editor, (1991) *Ethical Issues in Engineering*, New Jersey: Prentice Hall: 130 – 136. The author of this unit has taken some liberties in this presentation.

1. **Codes "confuse ethics with law-making"** (Ladd 130). Ethics is deliberative and argumentative while law-making focuses on activities such as making and enforcing rules and policies.

2. **A code of ethics is an oxymoron**. Ethics requires autonomy of the individual while a code assumes the legitimacy of an external authority imposing rule and order on that individual.

3. **Obedience to moral law for autonomous individuals is motivated by respect for the moral law. On the other hand, obedience to civil law is motivated by fear of punishment**. Thus, Ladd informs us that when one attaches "discipinary procedures, methods of adjudication and sanctions, formal and informal, to the principles that one calls 'ethical' one automatically converts them into legal rules or some other kind of authoritative rules of conduct...." (Ladd 131) Accompanying code provisions with punishments replaces obedience based on respect for the (moral) law with conformity based on fear of punishment.

4. **Codes lead to the dangerous tendency to reduce the ethical to the legal**. Ethical principles can be used to judge or evaluate a disciplinary or legal code. But the reverse is not true; existing laws cannot trump ethical principles in debates over ethical issues and ethical decisions. As Ladd puts it, "That is not to say that ethics has no relevance for projects involving the creation, certification and enforcement of rules of conduct for members of certain groups.... [I]ts [ethics'] role in connection with these projects is to appraise, criticise and perhaps even defend (or condemn) the projects themselves, the rules, regulations and procedures they prescribe, and the social and political goals and institutions they represent." (Ladd 130)

5. **Codes have been used to justify immoral actions**. Professional codes have been misused by individuals to justify actions that go against common morality. For example, lawyers may use the fact that the law is an adversarial system to justify lying. Ladd responds in the following way to this dodge: "[T]here is no special ethics belonging to professionals. Professionals are not, simply because they are professionals, exempt from the common obligations, duties and responsibilities that are binding on ordinary people. They do not have a special moral status that allows them to do things that no one else can." (Ladd 131)

*Mischievous side-effects of codes (from John Ladd)*

1. **Codes make professionals complacent**. (Ladd 135) First, they reduce the ethical to the minimally acceptable. Second, they cover up wrongful actions or policies by calling them — within the context of the code — "ethical". For example, the NSPE code of ethics used to prohibit competitive bidding. Enshrining it in their code of ethics gave it the appearance of being ethical when in fact it was motivated primarily by self interest. This provision was removed when it was declared unconstitutional by the U.S. Supreme Court for violating the Anti-Trust law.

2. Because codes focus on micro-ethical problems, **"they tend to divert attention from macro-ethical problems of a profession."** (Ladd 135) For example, in Puerto Rico, the actions of the Disciplinary Tribunal of the Colegio de Ingenieros y Agrimensores de Puerto Rico tend to focus on individual engineers who violate code provisions concerned with individual acts of corruption; these include conflicts of interest, failing to serve as faithful agents or trustees, and participating in corrupt actions such as taking or giving bribes. On the other hand, the CIAPR does not place equal attention on macro-ethical problems such as "the social responsibilities of professionals as a group" (Ladd 132), the role of the profession and its members in society (Ladd 135), and the "role professions play in determining the use of technology, its development and expansion, and the distribution of the costs." (Ladd 135)

## Activity 4.9

1. What are some of the objections to the codes of ethics?

## Summary

The code of ethics was introduced with the different uses, its functions and purposes and the difficulties of having to deal with codes. The section continued with a discussion on designing the statement of values by embracing a stakeholder code to develop the code of ethics for academics as well as for the organisational codes of ethics in terms of compliance and value orientation. In the final section, we have discussed the objections and the mischievous side effects of the code of ethics.

**Self-test 4.3**

A typical code of conduct for students.

Students are expected to adhere and practice the Code of Ethics while representing the university at all times:

1. Representation

   Every student is expected to represent him and her respectfully in all situations, whether orally or in written statement. Honest and respectful inclusive of but is not limited to, providing only truthful material information on all applications, financial aid forms, waivers, and any other official document. Students are also expected to behave respectfully to all administrators, faculty, staff, students, and visitors to the university environment and to behave respectfully when representing the University in any of the off-campus events. Students will not consciously misrepresent him or herself to any member of the University community or to any other person while representing the University.

2. Academic honesty

   Students are expected to maintain the highest standards of academic integrity. Work that is not of the student's own creation will receive no credit. If a student is uncertain of what these standards are, he or she may consult his or her instructor for appropriate counsel, but a student's ignorance is no legitimate defense for academic dishonesty. Academic dishonesty includes lying, cheating, stealing, and using unauthorised materials on any assignment, quiz or exam.

   If you see any students of the university violating the code of ethics, what will you do?

## Suggested answers to activities

### Feedback

**Activity 4.8**

1. Functions served by the codes include:

   a. **Discipline**. Most codes are set forth to establish clearly and forcefully an organisation's standards, especially its minimum standards of acceptable conduct.

   b. **Educate**. This can range from disseminating standards to enlightening members.

   c. **Inspire**. Codes can set forth ideals in a way that inspires a community's members to strive for excellence.

   d. **Stimulate dialogue**. Codes stimulate a vigorous internal debate.

   e. **Empower and protect**. Codes empower and protect those who are committed to doing the right thing.

   f. **Codes capture or express a community's identity**. They provide the occasion to identify, foster commitment, and disseminate the values with which an organisation wants to be identified publicly.

2. Some difficulties with the codes include:

   a. Codes can undermine moral autonomy by habituating us to act from motives like deference to external authority and fear of punishment.

   b. Codes often fail to guide us through complex situations. Inevitably, gaps arise between general rules and the specific situations to which they are applied; concrete situations often present new and unexpected challenges that rules, because of their generality, cannot anticipate.

   c. Codes of ethics can encourage a legalistic attitude that turns us away from the pursuit of moral excellence and toward just getting by or staying out of trouble.

**Activity 4.9**

Some of the objections include:

a. Codes "confuse ethics with law-making". Ethics is deliberative and argumentative while law-making focuses on activities such as making and enforcing rules and policies.

b. A code of ethics is an oxymoron. Ethics requires autonomy of the individual while a code assumes the legitimacy of an external authority imposing rule and order on that individual.

c. Obedience to moral law for autonomous individuals is motivated by respect for the moral law. On the other hand, obedience to civil law is motivated by fear of punishment.

d. Codes lead to the dangerous tendency to reduce the ethical to the legal.

e. Codes have been used to justify immoral actions.

# Summary of Unit 4

**Summary**

What is the key to winning over consumers today? Business experts will cite everything from a strong loyalty programme to a personalised, mobile-friendly shopping experience. These offerings are certainly important, but one thing that may tip the scales in the company's favour is using your profits to do good in the world — CSR. CSR is becoming more mainstream as forward-thinking companies embed sustainability into the core of their business operations to create shared value for business and society.

The recent major corporate scandals across the world from the late 1980s to the early 2000 have proved that the existing regulations are insufficient and inadequate. This has lead to the call for governments to incorporate more stringent regulations on the governance of public listed companies in order to protect the shareholders and stakeholders' interest. All companies are encouraged to adopt the principles and recommendations of Code of Corporate Governance (see Appendix) and make good corporate governance an integral part of their business dealings and culture.

Companies today are introducing code of ethics for all of its employees. The code of ethics will help to guide the employees' ethical behaviour in their day-to-day operations decisions. It will help to ensure that the employees will make the right decision when they encounter an ethical dilemma in their workplace. However, the code of ethics lacks a legally binding mechanism; therefore the local government enacts laws to regulate and to supervise its citizen, the companies as well as the state. For example, Bank Negara Malaysia is the utmost authority to regulate and supervise the financial system in Malaysia. They will ensure that all financial institutions within Malaysia comply with the regulations imposed by Bank Negara.

# Suggested Answers to Self-tests

## Feedback

### Self-test 4.1

1. It would be more suitable for a plumber to be a sole proprietor. This is because:

   a. Speed and ease of getting the business going.

   b. Sole-proprietors can take advantage of tax accounting fitted to business reality.

   c. Sole-proprietor business belongs to the owner: the owner can do whatever he/she wants with his/her company without fear of being taken over by someone else.

2. There are five ways corporation raise money:

   a. Issuing bonds — a written promise to pay a specific amount of money at a certain date in the future or periodically over the course of a loan, during which time interest is paid at a fixed rate on specified dates.

   b. Sales of common stock — shareholders of a corporation have certain legal rights including, in most cases, the right to vote for the board of directors who actually manage the company.

   c. Issuing preferred stock — A company may choose to issue new "preferred" stock to raise capital. Buyers of these shares have special status in the event the underlying company encounters financial trouble.

   d. Borrowing — Companies can also raise short-term capital — usually to finance inventories, by getting loans from banks or other lenders.

   e. Using profits — companies also can finance their operations by retaining their earnings.

3. The corporate director to "balance stakeholder interests" means balancing the interests of multiple stakeholders — investors, employees, customers, suppliers, etc., as one of their most persistent management challenges. Each of these diverse relationships imposes different requirements for negotiating the nature and content of the relationship and for communication between the parties.

4. a. Companies should engage in strategic philanthropy whereby good acts improve operating conditions and quality of life — and serve society.

   b. Companies should partner with non-profits and government agencies to solve social, economic, and psychological problems in society.

   c. Companies should meet or exceed stakeholder expectations of performance standards needed to satisfy the moral rectitude that business contributes to the long-term business climate by collaborative decision making and operating in the public interest.

5. Friedman asserts that the notion of corporate social responsibility is not only misguided, it is also dangerous as it threatens to violate individual liberty. The stronger the violation may ultimately lead to socialism.

   Economic freedom, as defined by Friedman, is laissez-faire capitalism or market activity with very minimal government assistance or regulation. Political freedom, as defined by Friedman, includes the freedom of speech, the freedom of religion, and the right to vote. Friedman asserts that socialist economic systems, whether they are Soviet-style system, social democratic systems, or even liberal welfare states, undermine political freedom. For example, in the socialist state, schools and other institutions of learning, the press, and even the judiciary may be subjected to state control, which indirectly denies freedom to its citizens.

**Self-test 4.2**

1. The primary feature of the stakeholder theory to corporate governance is that those who have a stake in the functioning of the corporation are made up of large and diverse groups. Simply put, stakeholders are those who seek some benefit from the optimum running of the corporation. Stakeholders have different goals and seek different benefits from the corporation. Workers seek job security, investors want dividends, and the community wants a solid economic base. The stakeholder theory holds that these different interests do, in fact, control the firm in their own specific ways, and none has any better right to have its voice heard than any other.

2. 95% of all Financial Times Stock Exchange (FTSE) 350 companies adhere to the principle that different people should hold each of these roles. However, in the United States, by contrast, most companies still combine them, although the idea of splitting the two roles is gaining momentum.

   Arguments for splitting the two roles:

   a. The separation of the chairman and CEO positions is a key component of board independence because of the fundamental differences and potential conflicts between these roles.

   b. A non-executive chairman can serve as a valuable sounding board, mentor, and advocate to the CEO. The relationship with the chairman based on mutual trust and regular contact is good for the CEO, shareholders, and the company.

   c. A non-executive chairman is ideally placed to assess the CEO's performance, taking into account the views of fellow board directors.

   d. It concerns the time needed to do both jobs and do them well. It can be argued that as companies grow more complex, a strong board is more vital than ever to the health of the company, and this requires a skilled chairman who is not distracted by the daily pull of the business and can devote the required time and energy.

**Self-test 4.3**

You should report the suspected incident to the relevant authorities in charge for a further investigation. However, if you should choose to remain anonymous, you should report the suspected violation or concerned to the University Helpline.

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