Working Paper

ETHICS, VALUES AND CORPORATE GOVERNANCE

By

N. Venkiteswaran

W.P. No. 1383
August 1997

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INDIAN INSTITUTE OF MANAGEMENT
AHMEDABAD - 380 015
INDIA

IIMA WORKING PAPER 1383

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N. Venkiteswaran

Indian Institute of Management, Ahmedabad

Abstract

In the context of the ongoing debate on corporate governance in India, this paper discusses the importance of ethics and values in corporate governance and underscores their importance in fulfilling the *raison detre* of the business enterprise, viz. delivering shareholder value. The paper examines the principal dimensions of corporate ethical conduct, particularly actions involving the less obvious conflict of interest problems, reasons for corporate deviance and concludes with a few suggestions to improve corporate ethical standards.

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Business institutions are at the cross roads. Their *raison d'etre* remains predominantly economic; yet the society continues to expect them to play roles far more than economic. On the one hand, the increasingly institutions-dominated and performance- driven investors are putting enormous pressure on corporate managements for delivering unfailing financial performance. On the other, globalisation of business, unprecedented competition and rapid technological change have combined to squeeze margins, shorten product life cycles and to greatly heighten business risks. On yet another front, expanding legislations, tireless special interest groups and an activist judiciary, while seeking to direct corporate social conduct, have certainly increased the costs of doing business. The problem is more acute for developing country corporates as they find their once-protected operating environment thrown open to sudden blasts of competition and invasion of developed country practices, without the benefit of either the structural flexibility or the cutting-edge technology of the latter. It may be tempting to dismiss the current debate on corporate governance in India as another of Western fads. Rather this is most timely and comes at a time when investor and public confidence have been shaken in all but a few of the 8000 odd listed companies, the public face of corporate India. It may not been an exaggeration to reiterate that India's ability to attract high levels of domestic and international investment so necessary to put it on a high growth path depends not inconsiderably on improving the quality of its institutional and

corporate governance. It should be somewhat reassuring to the cynic that even in a country like England, there is currently a raging debate on corporate governance, reopened with the recent submission of the Ronnie Hampel Committee Report.

The philosophical foundation for an issue like corporate governance is essentially ethical (and to an extent economic), though eventually the key elements do get legislative sanction. The crux of corporate governance relates to the manner in which top management, particularly, the board of directors, entrusted with the fiduciary responsibility of administering the savings entrusted to it by a large number of savers allocates the corporate pie *vis-à-vis* them and other interest groups such as employees, customers, government etc. The basic qualities expected in this regard are invariably *trust, honesty, integrity, transparency* etc. in the pursuit of its objectives and in managing the attendant internal and external interrelationships. There is an increasing body of public opinion that would expect the business enterprise to be much more than a mere economic unit, for example, to be a good corporate citizen who contributes vigorously to social causes and charity. This entire gamut could be referred to as the corporate ethical and value system.

This paper discusses some of these ethical and values-related aspects of corporate governance. It starts with a discussion on the shareholder vs. stakeholder approach to business enterprise, followed by an examination of the importance of ethics and values in corporate conduct. It then examines the major dimensions of ethical behaviour in the business institutional context and then goes on to discuss some of the possible reasons for the increasing instances of corporate deviance. It concludes with a few suggestions as to how to improve ethical standards in organisations.

Stockholders, stakeholders and corporate governance

Traditionally, the role of a business enterprise is viewed to be essentially economic with the ultimate objective of maximising the wealth of the owners.

The economist Milton Friedman may be somewhat blunt when he states,

> *In a free-enterprise .... a corporate executive is an employee of the owners of the business.........That responsibility is to conduct the business in accordance with their desires, which generally is to make as much money as possible* ***while conforming to the basic rules of society.***[1]
>
> (emphasis supplied)

A more expansive view is that any business institution has to pursue a broad stakeholder approach in the sense that it must attempt to balance the often conflicting interests of customers, shareholders, employees, managers, suppliers, the government and local community at large. We believe that these two views are not necessarily mutually exclusive, it is only a question of relative emphasis. It is important to underscore the fact that the main business of a business institution is in deed business and it must at the end of the day generate sustained surpluses for survival and growth - in short create wealth for the owners. Considering that most business organisations, including (increasingly) those in the public sector, are listed on the stock exchanges, this surplus generation and wealth creation process translates itself into value creation for *all* the shareholders as reflected in the long term growth in market price of the shares. Shareholder value management has to be accorded the status of *primus inter pares* amongst the various goals. Long term sustainability

of this goal-seeking would not only call for consistently wealth-creating decisions but also fair dealing with other stakeholders such as employees, customers and suppliers and the society. Similarly creating consistent surplus and shareholder value is a necessary requirement for being able to carry out social responsibility and charitable acts. The goal itself, though appearing to be narrow, is far more all-encompassing and comprehensive than what is commonly understood. This also implies a strong long-term orientation, but without necessarily sacrificing the short-term.

The importance of delivering shareholder value can be seen from the fact nearly 25 to 30 percent of the companies (about 2500) listed on the Indian stock exchanges are currently quoting at a fraction of their issue prices and many are quoting as low as a rupee. This has wiped out investors' wealth, more importantly their confidence. Scores of companies have done the vanishing act leaving not even the addresses of their registered offices! True it is, in several cases the business failure may be due to strategic mistakes or poor business judgement in the liberalised competitive environment. But in a large number of cases, the failure stems from either *malafide* intent or downright insensitivity. In these cases at least, it may not make much sense to talk of broader goals, while they seemed to have failed in their *raison d'etre* of delivery any value to the investors.

To most observers of Indian corporate scene, there appears to be very little in India by way of meaningful corporate governance. How else can one explain the fact that scores of Indian companies have their shares suspended or delisted by stock exchanges for non-compliance with the none too onerous listing regulations? And company managements go scot-free, even as investors are left

in the lurch with no exit route. Unless corporate boards explicitly pursue policies that create, enhance and sustain shareholder value, a business enterprise would lose its vibrancy and so would the future of other stakeholders such as employees and suppliers. Historically Indian corporate sector dominated as they have been by the public sector and family groups, never devoted explicit attention to the interests of the non-management shareholders. And this has to change, and change fast.

A word of caution. Emphasis on shareholder value should not mean disregard for the interests of other stakeholders. Rather, the sustainability of the shareholder value goal would mean constantly responding to the changing needs, aspirations and requirements of the other stakeholders as well, without whose support and willing participation, the former cannot be delivered. As Brickley, Smith and Zimmerman point out, *maximising firm value, in fact means, devoting resources to each important corporate constituency to improve the terms on which they contract with the company, to maintain the firm's reputation....... More precisely, it means allocating corporate resources to all groups or interests that affect firm value.*[2].... At the same time giving primacy to shareholder value would help in establishing viable decision rules and criteria for arriving at corporate decisions and their evaluation. The challenge of corporate governance lies in managing the continuously evolving conflict of interest situations, balancing the diverse interests of various stakeholders of the business institution. It is here that ethical dimension of corporate conduct and governance becomes important.

Ethics and values dimension in corporate context

There is considerable evidence that firm valuation (one of the main corporate objective as discussed above) is, *inter alia*, influenced by corporate reputation and goodwill, which in turn are shaped by its value system, ethical sensitivity and credibility. In an enterprise context, ethical conduct always implies ethical behaviour by the enterprise's managers and employees, which as Brickley *et. all*[3] point out typically includes the following.

- Compliance with the various laws and regulations of the countries in which the enterprise operates.

- Honesty and integrity in dealing with customers, employees and other stakeholders.

- Avoidance or otherwise resolving conflict of interest situations.

To these can be added a fourth dimension:

- Practice of corporate social responsibility, which "seeks to make management responsible upholding for a broader spectrum of democratic values".

Of the above, the need for compliance with the statutory rules and regulations of the host country is far too obvious. The statutes will just have to be complied with. Not only from the point of view good corporate citizenship, but simply from the point of business expediency and corporate and personal reputations. Obviously compliance with the hundreds of regulations would involve costs, and it may be tempting to indulge in trade-offs. But it must be recognised that these costs are in deed costs of being in business. Leaving compliance to the

discretion of various officers based on individual trade-off decisions is the surest way of installing corporate time bombs, that could explode any time, any where. Just as the board of an Indian company would expect its officers located in various states to comply with the local regulations, it is equally incumbent upon the chief executive of a multi-national corporation (MNC) to ensure that its subsidiaries all over the world comply with the host country statutes and regulations. This is thus strictly not an ethical issue, but a legal issue.

But the ethical dimension of a legal issue arises when compliance involves meeting the letter of laws and not necessarily the spirit. Compliance with the letter of law is matter legal; but if one goes beyond and comply with the spirit of laws, one would also be ethical. We may add that being ethical in this sense adds to greater legal certainty in an era where there already multitudes of uncertainties and risks.

Take the case of Minimum Alternative Tax (MAT) in India. Without getting into the pros and cons of MAT itself, one may point out that the same was introduced after a fair amount of public discussion and debate. The spirit of MAT is that profit-making, but otherwise non tax-paying companies should pay some minimum tax in *any* event. One can still come up with - as several companies have in deed done - accounting acrobatics to nullify or minimise the impact of MAT; but Revenue is bound to catch up, possibly retrospectively. So the advantage may often turn out to be ephemeral and not lasting. Since market does not like this uncertainty, share valuation (for which all this is presumably done) is unlikely to be helped either. The casualty would be corporate credibility, with its own explicit and not so explicit costs.

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Another facet of ethical conduct is honesty and integrity in dealing with customers, employees, creditors and shareholders. Every employee of an enterprise should have credibility at two levels for him to succeed in all his dealings - credibility of the organisation and of his own. One without the other may not be sufficient for building and sustaining successful relationships. Credibility would include qualities such as honesty, integrity and commitment - qualities that are difficult to monitor and ensure compliance. Besides the fact every human being would expect to treated in this manner, this should also make sound business sense in establishing and sustaining invaluable networks with customers, suppliers, lenders and local authorities that may turn out to be powerful and sustainable competitive advantage.

The third aspect, viz., avoiding conflict of interest situations is often much more subtle and not that obvious, and is even more difficult to monitor because there may not be even agreement about the ethical dimensions thereof. Moreover it is very often the top management that indulges in actions involving serious conflict of interest, often under the guise of business judgement. The following is an illustrative list of typical transactions involving serious conflict of interest routinely practised by corporate managements (some of which may be more common in India).

- Routing of transactions (e.g., exports, purchases) through private companies owned and controlled by top managerial personnel or the so-called promoters (a delightfully vague term in the Indian context) in a *less than arms' length manner.*

- Promoting multiple business enterprises dealing in the same product-markets. (In one case, a publicly-held company was not allowed to

realise its true potential, as that would have meant competition to a privately-held company in the same promoter group.)

- Establishing *new* 100% subsidiaries by multinational corporations in direct or indirect competition with their existing arms with public shareholding.

- Merger of dud companies, often privately-held, with publicly-held companies as salvage/face saving operation.

- Intercorporate investments and lending. In India, more often than not intercorporate investments and lending turn out to be in pursuit of some personal agenda of the promoters/top management and against the interests of the larger body of shareholders of the investing companies.

- Payment of royalties without involving explicit quid pro quo, as one is witnessing in India today. In several cases, a well known brand is either owned by or transferred to or vested with a foreign parent or a closely-held promoter company. The same is licensed in favour of a listed company (with substantial public investment) for a limited period of 4 to 5 years on each occasion. It is the licensee company that promotes the brand that it does not own through heavy advertisement and promotion expenses, and on top, is also charged an on-going royalty.

- Appointments to top managerial positions on considerations other than merit.

- Corporate decline/break-up arising from promoter differences.

Transactions involving actual and potential conflict of interest, no doubt, are not limited to any particular country, category or ownership class. In one of the largest ever and most celebrated acquisitions of the $25 billion leveraged buy-

out of RJR Nabisco in the US, the company was put in play by none other than the Chairman of the company bidding for it! [§]

Much of the conflict of interest situations lead to what financial economists refer to the agency costs, arising from the difficulty in ensuring that corporate managers and employees perform in a manner consistent with the interest of owners or shareholders. That is, corporate managers tend to act in their own interests and at the expense of the shareholders. Typical of the agency costs is the proneness to splurge company's cash flows on mega projects of doubtful value and in high premium acquisitions, rather than distribute back to the shareholders in the absence of value creating investment opportunities. This is because returning cash back to the shareholders could be synonymous with corporate stagnation, if not shrinkage, and both of these may neither add to the prestige nor to the remuneration of the managers concerned. So in the name of dubious growth and non-existent synergies, managers pursue acquisitions, which is the surest means to acquire size in double quick time. Similarly when confronted with an unwelcome take-over, the target company managers look for "white knights", essentially motivated by their own survival instincts. The vast array of take-over defence mechanisms instituted by companies have been

§ It was quite another matter that the Special Committee of the Board consisting of outside directors, handled the sale of company with tremendous professionalism, laying out as level a playing field as possible amongst the various bidders.

essentially driven by managerial self interest rather than the interests of other stakeholders. Empirical findings, for example, confirm that anti-takeover measures are shareholder value destroying.

The situation in the Indian context is somewhat different compared to the typical situation of the West in which professional managers with very little ownership stake in the companies they manage have little incentive to align their actions to the interests of other stakeholders. In India the problem appears to be exactly opposite - in most cases managers are the promoters with large equity stakes, and yet there is misalignment of interests. This may be due to the potential opportunity to make private gains when placed in the management, gains that need not be shared with other stakeholders including the government.

Ethical conduct and corporate goals

Even in the context of an enterprise pursuing a predominantly shareholder value-oriented approach (rather than a stakeholder approach), a high level ethical conduct and value based governance is called for. Financial and product markets are extremely "old-fashioned" when it comes to human behaviour and corporate conduct. Market's continuous assessment and evaluation processes (leading to eventual valuation) give a fair amount of weightage to dependability and integrity of a company's management and employees - in short the quality of its governance. From Barings to Nomura, from Drexel to Union Carbide - all stakeholders and the entire enterprise suffered irreparable loss due to irresponsible conduct and deviant behaviour somewhere in the organisation -- and in the case of Barings, that of just one man. As noted earlier, ethical conduct and fairness and transparency in corporate dealings create and sustain corporate brand equity and reputation, that at the mundane level ought to

translate into declining market share and market valuation of shares of the company concerned. For example, in the immediate aftermath of the announcement of Salomon Bros.' involvement in the US treasury-auction scandal, it lost its market share sharply. Back home we are witnessing the prospects of an entire industry - that of aqua culture - being wiped out by judicial intervention on ecological grounds. No doubt investors, lenders and employees are to lose heavily because enterprise after enterprise was sought to be built on socially irresponsible foundations. We are also witness to apparently well-performing companies suffering poor market valuation on grounds of "group discount", a market euphemism to denote that investors just do not trust the promoter/management group. Similarly valuation of a enterprise suffers major declines when it becomes known it was to be embroiled in a major, regulator-initiated litigation.

Thus it is obvious that having high ethical standards and value-based approach are important elements even in a predominantly shareholder value oriented approach. Any corporate governance system, therefore, has to necessarily be a value-based approach.

Reasons for unethical corporate conduct

In the absence of empirical evidence it may not be appropriate to assert that ethical standards and values are declining particularly in the business context. However there is a widespread perception that "ethical business" is a contradiction in terms, implying that ethics and business cannot co-exist. It should be a matter of great national concern and shame that there is an increasing perception in domestic and international circles about the poor ethical standards in Indian business and industry. While noting that there is cultural

dimension to the problem world-wide, it may be useful to examine the possible reasons for ethical failures.

One of the principal reasons for deviant behaviour could be the tremendous pressure to perform in an environment that has become extremely competitive in every facet of human endeavour. The tendency to cut corners, thus, could come from the need to win - in all situations. Another reason could be outdated control systems. Since business enterprises have expanded in size, scope, complexity and geographical spread and have become highly decentralised, it has become virtually impossible for the central management to monitor and keep track of micro level operations and deviant conduct of individual or groups of employees. It is not surprising that at least in a number of instances such as Barings and the Indian Security Scam, the reasons have been identified (control) systems failure. It is also true that company management is generally reluctant to spend resources to upgrade internal systems and processes until it is too late. Moreover enterprise managements seldom ever conduct formal training sessions to sensitise their employees to the organisation's attitude to ethics and its value system.

Economists argue that conflict of interest situations and consequent agency problems are largely the result of flawed organisational design and absence of goal congruence.

At least in the Indian context it is possible that much of the ethical problems one witnesses may have been the result of an excess of onerous legislations. This could be due to, as Jensen and Meckling[4] points out, the government's "failure to recognise creativity" of what they refer to as the Resourceful, Evaluative, Maximising Model (REMM) of human behaviour. REMM states that every

individual cares, he or she is an evaluator and maximiser with unlimited wants, and resourceful. The model can be explained with reference to the widespread perception of large scale tax-evasion in India. This, we believe, has been perfected into a fine art on account of very high levels of tax rates. When maximum marginal tax rate was 97.75%, with wealth tax on top of that, there was every incentive for the tax payer to evade tax, as the trade-off was in deed phenomenal. (Now that tax rates are down to reasonable levels, it is still a moot point whether settled human behaviour and response pattern can change overnight).

Improving ethics and value system

What can be done to improve the ethical conduct and value system at the business enterprise level? Considering that that there is a positive correlation between values and valuation, there ought to be every incentive for top management to establish and nurture ethical practices and value based processes throughout the organisation. Not only that the board articulates in clear, unambiguous language the corporate “dos and don'ts” and its expectations from the employees, it has to constantly reiterate the same in its communications and publications. There should be regular training and sensitisation programmes on the corporate value system and acceptable behaviour pattern. Company should encourage an environment of openness. More importantly the company's performance evaluation and reward system should not only be outcome oriented, but also should lay emphasis on behaviour and process aspects of achieving the results.

Similarly we believe that corporate governance should begin to lay emphasis on compliance with the spirit rather than mere letter of the various laws. This would,

besides enhancing the enterprise credibility, would also minimise legal risks and uncertainties. To avoid conflict of interest actions, the board could establish a stakeholder impact assessment system to evaluate all major corporate decisions. This would involve the identifying and assessing, both quantitatively and qualitatively the impact of major corporate decision (say an investment, acquision or divestiture) on various stake holders such as managers/promoters, shareholders, employees, customers, creditors and even tax authorities. Based on such an appraisal, the board of directors, particularly the outside directors, could an independent, balanced decision on the issue on hand.

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[1] Milton Friedman, *The Social Responsibility of Business is to Increase Its Profits,* Ethical Issues in Business, ed. Thomas Donaldson and Patricia Werhane (Englewood Cliffs, Prentice-Hall, 1979) pp 191-7.

[2] James Brickley, Clifford W. Smith, and Jerold Zimmerman, *Ethics, Incentives and Organisational Design,* The BankAmerica Journal of Applied Corporate Finance, Summer 1994, pp 20-30.

[3] James Brickley, Clifford W. Smith, and Jerold Zimmerman *(opp.cit.)*

[4] Michael Jensen and William H. Meckling, *The Nature of Man,* The BankAmerica Journal of Applied Corporate Finance, Summer 1994, pp 4-19.