Business Ethics
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Lecture - 23
Ethical issues in corporate governance

Now, we will discuss the ethical issues in corporate governance. As we have seen in the last discussion, when we are discussing the principal agency relationship, where the shareholder is the principal, and the management is the agent. There could be some conflict of interest in what the shareholders want from the corporate, and what is the managers want from the corporate. Regarding the shareholders once more of profit and the management also through because they are involved in the day-to-day management of the business because they are the people who were taking major decisions for the corporate. So, they demand more prestige, more remuneration from the organization in return of the work that they are putting into the organization.

To deal with this problem like the conflict of interest does not hamper the smooth functioning of the organization, and to deal with other ethical issues with related to corporate governance, then the a body is there which looks into which overseas how the management is functioning.

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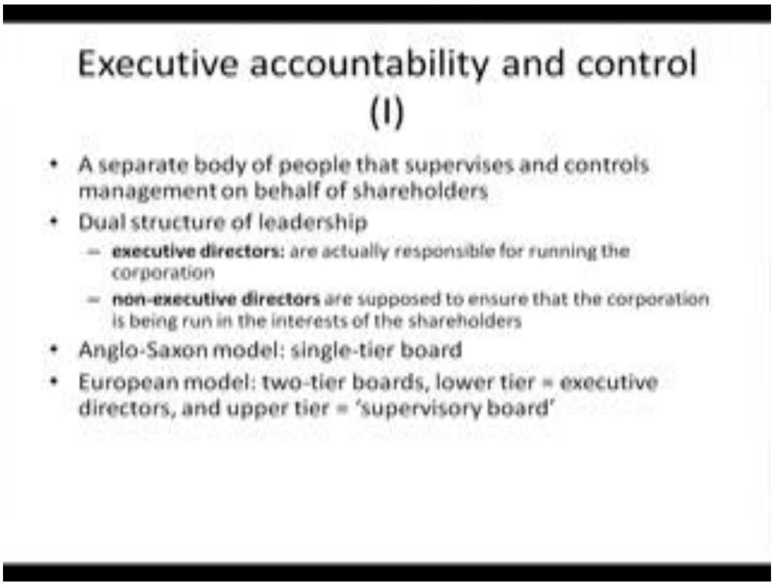

This body is called executive accountability and control. This is a separate body of people that supervises and controls management on behalf of shareholders. So, these are called executive or non-executive directors. So, directors are separate body of people that supervisors and controls management on behalf of the shareholders. And there is a dual structure of leadership. There are executive directors and there are non-executive directors. Executive directors are actually responsible for running the organization; and non-executive directors are supposed to ensure that the corporation is being run in the interest of the shareholders.

According to the Anglo-Saxon model, there is only a single-tier in their board where the executive directors and non-executive directors are there together. But in the European model, it is a two-tier board. The lower tier is the executive directors, and the upper tier is the supervisory board or the non-executive directors who over sees the functioning of the organization to ensure that the corporation is being run in the interest of the shareholders.

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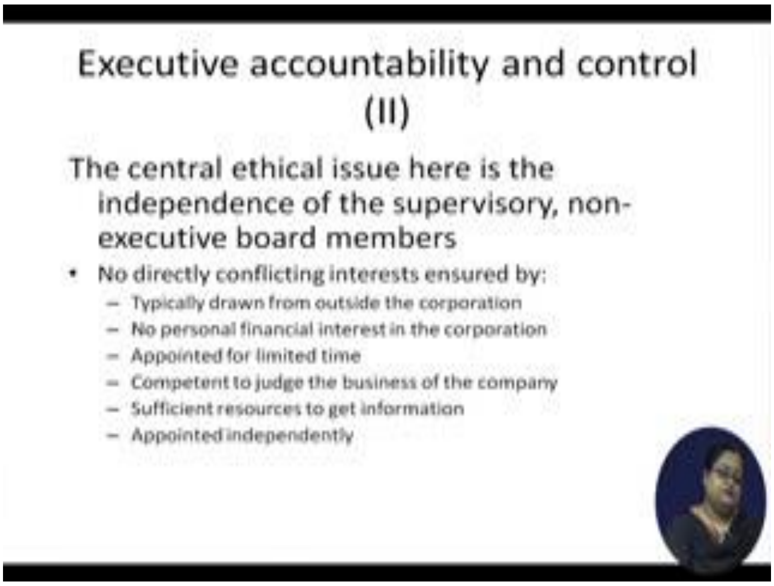

So, we can understand the non-executive directors have a major role to play to determine whether the management is operating based on ethical principles, and whether they are doing justice to the shareholders money or not, whether they doing justice to the other stakeholders also. So, it is very important that the independence of the supervisory are non-executive board members are very essential, so that they are not having any personal self-interest in the organization.

Let us see now find out what are the ethical issues in the independence of the supervisory executive board members. To ensure like they do not have any directly conflicting interest with the organization, where like their personal interest are coming in way of the organizational interest to ensure that it is way that the non-executive directors are drawn are majorly from outside the corporation. They are members who are taken from outside the corporation. They are people who do not have any financial interest in the personal financial interest in the corporation.

The appointment is for a limited time, so that they do not start identifying with the organization as my organization, and find it like a piece of like investing in their self-interest. So, the appointment is for a limited time. Then as non-executive directors, those members are taken only those who are having the capability to judge the business of the company. They are competent enough to judge the business of the company. They must also be having sufficient resources to get information about the things happening within the organization to do a proper survey to extract information from the organization about things happening inside the organization.

Next, they should be appointed independently by the stakeholders, and there appointment should not be such like, they are having any personal interest self-investment of self-interest in the organization. So, these are pointers to check like the non-executive board members who are expected to be in the supervisory role to determine whether the management is functioning according to the interest of the shareholders or not is very critical and done with at most care.

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All these things are audited by an independent auditor who is again appointed independently to see like the total functioning of the organization is stand in a proper way. However, the ethical issues that may generate due to these factors are first is that a executive remuneration. Though it is discussed like the non-executive board members have to be independent in nature, they are not having any vested self-interest in the organization. It is very difficult to reach this situation and when it is stole like the gate paid according to their time invested and also the get paid in the other benefits based on the time invested and the other involvements then that also sometimes becomes an issue of ethics.

One of the major ethical issues that have cropped up in the field of ethical issues in corporate governance is that of executive remuneration. In many cases, it has been seen the executives enjoy a fat cat salary, huge salary which is much beyond what the shareholders are getting their profit as. So, CEO increases the salary and it is beyond or it is sometimes does not take into consideration also, the shareholder returns. Questions may come up regarding the ethical issues may come up regarding why the shareholders are going to pay for an executive, who may not have performed well or during their period the organization did not perform well. So, it is the function of the executive to see that the organization is functioning to the best interest of the shareholder and it functions well. It has to survive and grow then why in many cases where these CEOs like the mismatch of the salary that were discussing about.

Why the shareholders need to pay for the executive salary even during the term when the corporation is not maybe performing financially very well, why do they need to pay for their benefits. The CEOs is the debatable ethical question, the answer to which is not yet very clear because people have again (Refer Time: 12:58) with different ways of thinking and their viewpoints to it.

The ethical problems with to deal with the ethical problems with the executive pay, it has some company it has been decided to performance related pay. However, these may performance related pay and then there give speed in terms of currencies which all shareholders understand there is paying in terms of giving them shares in the organization at a future price. And because it is not only the organization is taken care of the number of shares given it is taking care of the you have to equate to the wealth of the executives also. So, this giving of shares to the non-executive board member may also act counter to the fact they have to maintain independence in the organization and it mainly large salaries that cause unrest within the organization and unless in the mind that other shareholders are also.

The influence of globalization and executive pay is to significant increases because as we have seen like there is a difference in the like frameworks of corporate governance. So, also, so the executive remuneration varies across regions and with the globalization coming in. So, there are possibilities like the even after taken care of performance related pay due to globalization, executive remuneration is going to increase more. And these are significant increases and it with respect to the returns got by other shareholders.

The board often fails to reflect on the other shareholders or stakeholders interest, and this is called the limited influence of the board. These are issues which are issues of debate and the concrete answer to these are not yet available like why should shareholders take the burden of paying an executive whose during whose done your organization has not performed well. So, do we allow increasing of the executive salary which increases the gap between the lowermost level of employee in the organization and the CEO? So, what difference level of difference should be allowed sanctioned within the organization. So, these type of issues are still debatable issues are need to be solved in future.

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Another issue when rise from the ethical aspects of mergers and acquisitions. Mergers and acquisitions transfer of assets to from one owner to another owner in the expectation that the new owner will be even to use this assets for the best interest of the shareholders use them properly, help them to reach a goal, and make business out of it and give a proper return to the shareholders. And it is to be used in a more productive way. So, however, there could be some ethical issues in mergers and acquisition like during this transference of assets, whether it is more important like the executive prestige or the profit and the share price. And how the executives are going to act during this merger and acquisition phase are very important.

Two different or two alternatives are possible. The first is called the golden parachute. In golden parachute, what is done the organization which may enter into relationship into with the executives and seduce them with the golden parachute for corporation which means they are given a very high amount for making this merger, they are given a very high amount for making these merger happen, and also to accept their redundancy. So, they have this golden parachute talks of two things the it is an agreement during which may be the organization which is doing this hostile takeover is seducing the executives to say put their no (Refer Time: 20:36) for the merger to happen and also to accept their redundancy in return for a huge amount of money.

The opposite is at the greenmailing. Greenmailing is opposite to blackmailing where in greenmailing, the executives they send some secret mails to the organization who is making the hostile takeover to hinting that they will buy back the share in a future time with paying money which is more than the current market value. And then thus they retain their job within the organization. They secure their job with the organization after merger by using the corporate money. So, these generally happens in cases of hostile takeovers where an investor or a group of investors intent to purchase a majority of the stake in a particular organization against the wishes of the board. And there we find shareholders can have two types of views; one view is that they want to sell, but other prominent view is that they do not want to sell their shares.

And through the process of golden parachute, the executives like are approached by the organization making the hostile takeover with large sum of money to ensure that they will help in the other shareholders to agree to the merger and in return they will also accept their own redundancy. The greenmailing is also in the same context of hostile takeover, where the managers are securing their own job in the future organization at the cost of the corporate money.

The intentions and the consequences of mergers and acquisition, in many cases are restructuring and downsizing. Sometimes in mergers and acquisitions, why these mergers are happening, what are the relative powers of the two firms which are getting merged together, and who is going to share the how the power is going to get shared post-merger these information are not there with the shareholders, small shareholders mainly at large. So, it may so happen that the merger and acquisition is done only for getting control of the assets which are more worthy in nature to spread one's own business to get the reputation, the brand name. And in that effort what is mainly done after the mergers and acquisition are the restructuring and downsizing of the acquired firm, where the employees are the main target, and the people have to leave after acquisition is being done.

So, this may make the post-merger and acquisitions, the new firm formed may be more productive, but it may so happen that the demands and rights of some stakeholders beyond the shareholder only gets sacrificed. So, whether the other stakeholders writes a demands are also answered properly respected in the post-merger situations, so that becomes a point of debate again, because it mainly focuses to restructuring and downsizing.

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Another problem that may arise from the principal agency relationship is that of asymmetry of information, which may give rise to two things, the faith stocks and the insider trading. Faith stocks are what the here the organization has not really made any profit but based the executives based on their present performance have predicted the future performance. And that results in that is based mainly on speculation, and these speculations do not reveal in reality the total amount of uncertainty involved, because all the stakeholders may not have an access to the true performance of the organization, the executive directors the management. They can sometimes hook up the performance of the organization, and may it look like that it is performing well, and may hide the risk involved. So, this speculation may not have strong basis on the present performance or the present performance maybe (Refer Time: 29:04) presented also.

When we are focusing on insider trading this is based on the asymmetry of information that the agents have due to they are members or the executive have due the fact like they have got information from inside the organization which maybe other shareholders are who are not there in the board are not having access too. So, it is an access to inside information of the organization based on its present and potential future performance which the other shareholders, who are not directly involved with the running of the business do not have an access too.

Insider trading occurs when securities are bought and sold on the basis of material non-public information. So, the word non-public information is very important. The ethical issues involved in this because there was a lot of debate regarding whether insider trading is ethical or not, should the accountants, should the analysts, who have got some information from the organization, after doing detailed analysis, should they be sharing it with all, should not they be using it for dealing with their shares. Because these days as discussed the executives are paid in terms of shares in how they are buying or selling the shares by using this knowledge. Then why they are going to share it with the all the shareholders, because it is their hard work or knowledge that they have gained about the organization. So, these type of controversies, these type of dilemma give rise to ethical arguments with respect to insider trading.

The four major ethical arguments with respect to insider trading are first is finance, second is misappropriation of property, third is harm to investors and the market, and forth is undermining of fiduciary relationship. Fairness is inequalities of information brought by the people work all insiders and people who are outside the organization that is why you just thought to bit ethical issue. Misappropriation of property is when based on these information that the insiders may have, they may start selling their shares or buying shares from outside. So, this is called misappropriation of property.

Harm to investors and the market because they have the access to information because others do not have the access to information. So, others even if they want, they cannot take proper steps in how they are going to behave with respect to the shares that they are having for this organization. So, this in the long run may erode investors trust in the organization and so it is unethical in nature.

There is a fiduciary relationship between the management and the shareholders. By using this power gained through insider trading, then it is undermining of the fiduciary relationship, the trust relationship where they have to managers have to think of the shareholders whose money the organization has taken and put in business. Rather than what here it is been done the organizations resources are used by the insiders to get such an information which they use before it becomes public, before other shareholders are having access to these information and they use it for their own self interest. So, this undermines the fiduciary relationship and leads to this leads to ethical arguments. So, as we have seen it erodes the trust of the investors for this organization in the long-term and thus it is illegal thing and insider trading is to be avoided.

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The role of financial professionals and market intermediaries, because insider trading are happening, because shareholders are not having proper access to all the information about the organization. The accountants are expected to provide true and faired view of the firm and bridge the information asymmetric, which is there between the shareholders at large, and the executives or the managers inside the organization.

However, there are five main problematic aspects of financial intermediary's job. First is the power and influence in the market, like by auditing for a particular organization and they gain power, and they may use this power and influence later in negative terms. Conflict of interest, they may be auditing for different clients and cross-selling of information is also possible. By entering by editing for a particular firm on for a long basis though these auditors are taken to be independent auditors who are like maintaining fairness in reporting, the true performance of the firm. Then this long-term relationship with the clients they obligate them to show the firms performance in a positive light. The size of the firm for which they are auditing is also very important. And there could be competition from other audit firms.

So, in the urge to get a business and to retain the relationship with the corporate, the auditors may reserve in to unethical ways of responding. Another change in perspective of accounting and auditing is with the changing nature of demand, the accountants and auditors are along with checking of previous statements and finding out whether the performance of the organization is like ok or not, and what is the true performance. They have to think of the potential shareholders also and may have to predict the future performance of the organization. And this based on the past performance. And this in order to give a picture of the organization to the potential shareholders, this is called creative accounting, and may give rise to like talking about faith stocks.

So, this is another of the ethical issues when we are dealing with the role of financial professionals, and market intermediaries in like where you accountants and credit rating agencies with respect to corporate governance.

Thank you.