LISBON SCHOOL OF ECONOMICS & MANAGEMENT
UNIVERSIDADE DE LISBOA

ÉTICA

Mestrado em Contabilidade, Fiscalidade e Finanças Empresariais

Ethics & Governance

Topics

- What is the corporation's role?
  - Betaseron Case
- Corporate accountability – stakeholders
- Theories of corporate governance
- Governance – definition & purpose
- Basic governance functions
  - Kardell Paper Case
- Board of Directors:
  - accountability, fiduciary & other duties, structure, legalities

Support for a Business

- Credibility that stakeholders place in corporate commitments
- Company’s reputation
- Competitive advantages
    - Emerging Governance and accountability
- Stakeholders interests and ethical matters

TABLE 1.1

FACTORS AFFECTING PUBLIC EXPECTATIONS FOR BUSINESS BEHAVIOUR

Unbridled greed	Subprime lending fiasco, CEO over-compensation
Physical	Quality of air and water, safety
Moral	Desire for fairness and equity at home and abroad
Bad judgments	Operating mistakes, executive compensation
Activist stakeholders	Ethical investors, consumers, environmentalists
Environmental Reality	Environmental degeneration, need for sustainability
Economic	Weakness, pressure to survive, to falsify
Competition	Global pressures
Financial malfeasance	Numerous scandals, victims, greed
Governance failures	Recognition that good governance & ethics risk assessment matter
Accountability	Desire for transparency, corporate social responsibility (CSR)
Synergy	Publicity, successful changes
Institutional reinforcement	New laws – environment, whistle-blowing, recalls, *U.S. Sentencing Guidelines*, OECD anti-bribery regime, *Sarbanes-Oxley Act* (SOX) reforms, professional accounting reform, globalization of standards (IFAC, IFRS) and principles (Caux), *Dodd-Frank Wall Street Reform & Consumer Protection Act*

Factors affecting expectations for business behaviour

- Environmental concerns
- Moral Sensitivity
- Bad Judgement & Activist Shareholders
- Economic & Competitive pressures
- Financial Scandals: the Expectations Gap & the Credibility Gap
- Governance Failure & Risk Assessment
- Increased Accountability & Transparency desired

Factors affecting expectations for business behaviour

- Synergy among factors & institutional Reinforcement
- Outcomes
- New Expectations for Business:
  - New mandate for business
  - New Governance & Accountability Framework
  - Reinforced Fiduciary Role for Professional Accountants

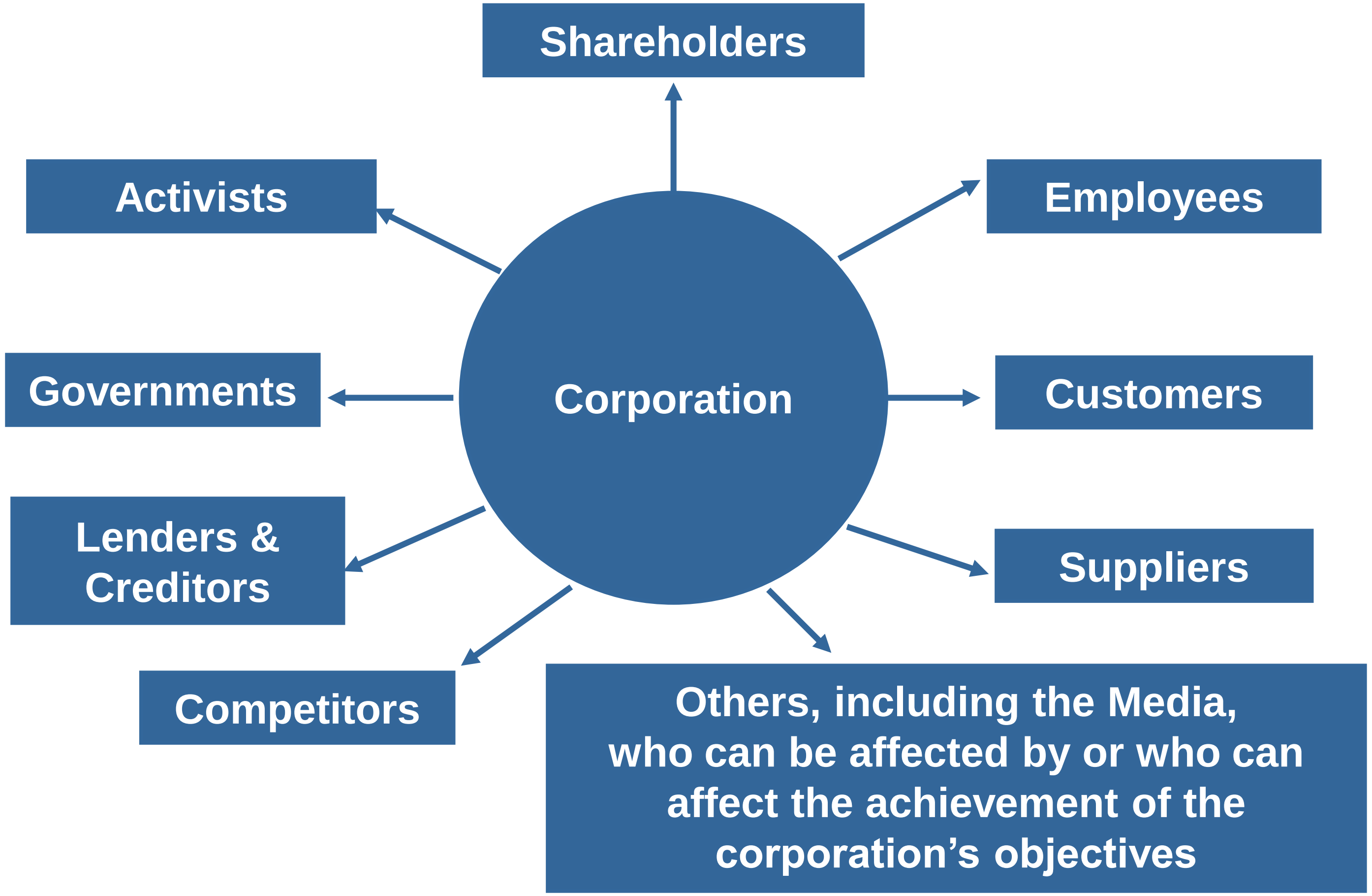
Responses and Developments

- Emerging Governance & Stakeholder Accountability model – fig 1.1; fig. 1.2

- Management based on values, Reputation and Risks – fig. 1.3

FIGURE 1.1

MAP OF CORPORATE STAKEHOLDER ACCOUNTABILITY



Good Ethics & Governance – Key Stakeholder Support is Vital to Success

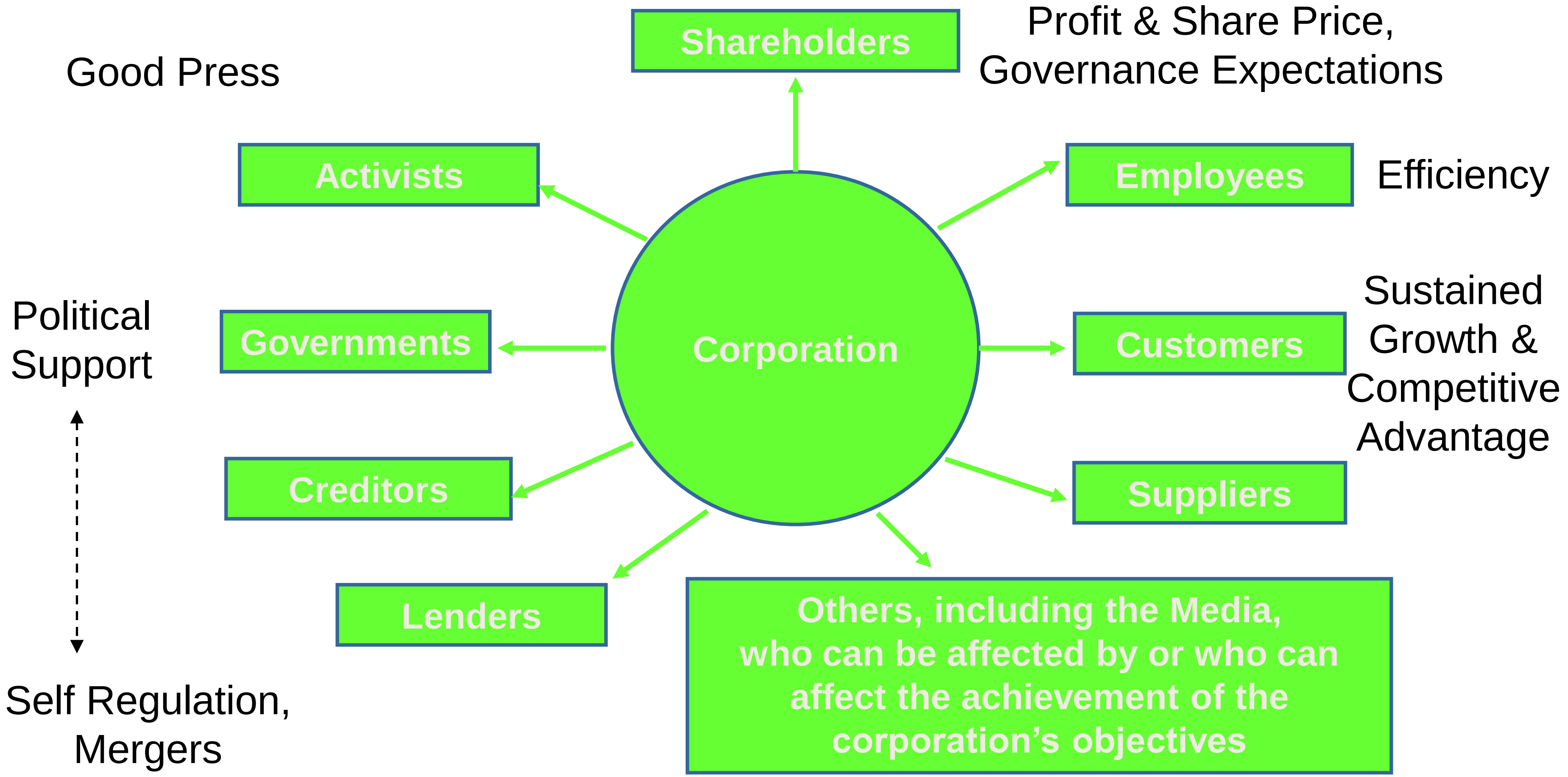
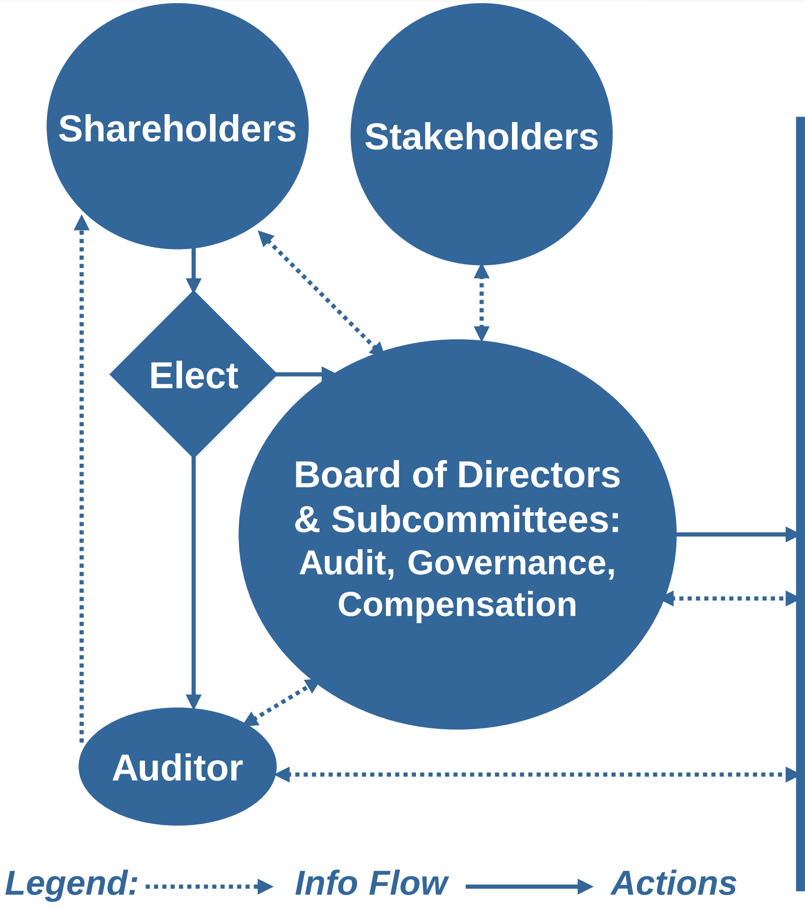


FIGURE 1.2

CORPORATE GOVERNANCE FRAMEWORK



Key Board Control Functions:

- Set Guidance and Boundaries
  - Policies, Codes, Culture, Compliance – laws, regs, rules
- Set Direction
  - Strategies, Goals, Remuneration, Incentives
- Appoints CEO, who appoints other executives, and CFO
- Arrange for Resources
- Monitor Feedback
  - Operations, Policy Compliance, Financial Reports
- Reports to Shareholders, Govern.
- Nominates/decides on Auditor

TABLE 1.2

HYPERNORMS (BASIC VALUES)
UNDERLYING STAKEHOLDER INTERESTS

A hypernorm is a value that is almost universally respected by stakeholder groups. Therefore, if a company's activities respect a hypernorm, the company is likely to be respected by stakeholder groups and will encourage stakeholder support for the company activities.

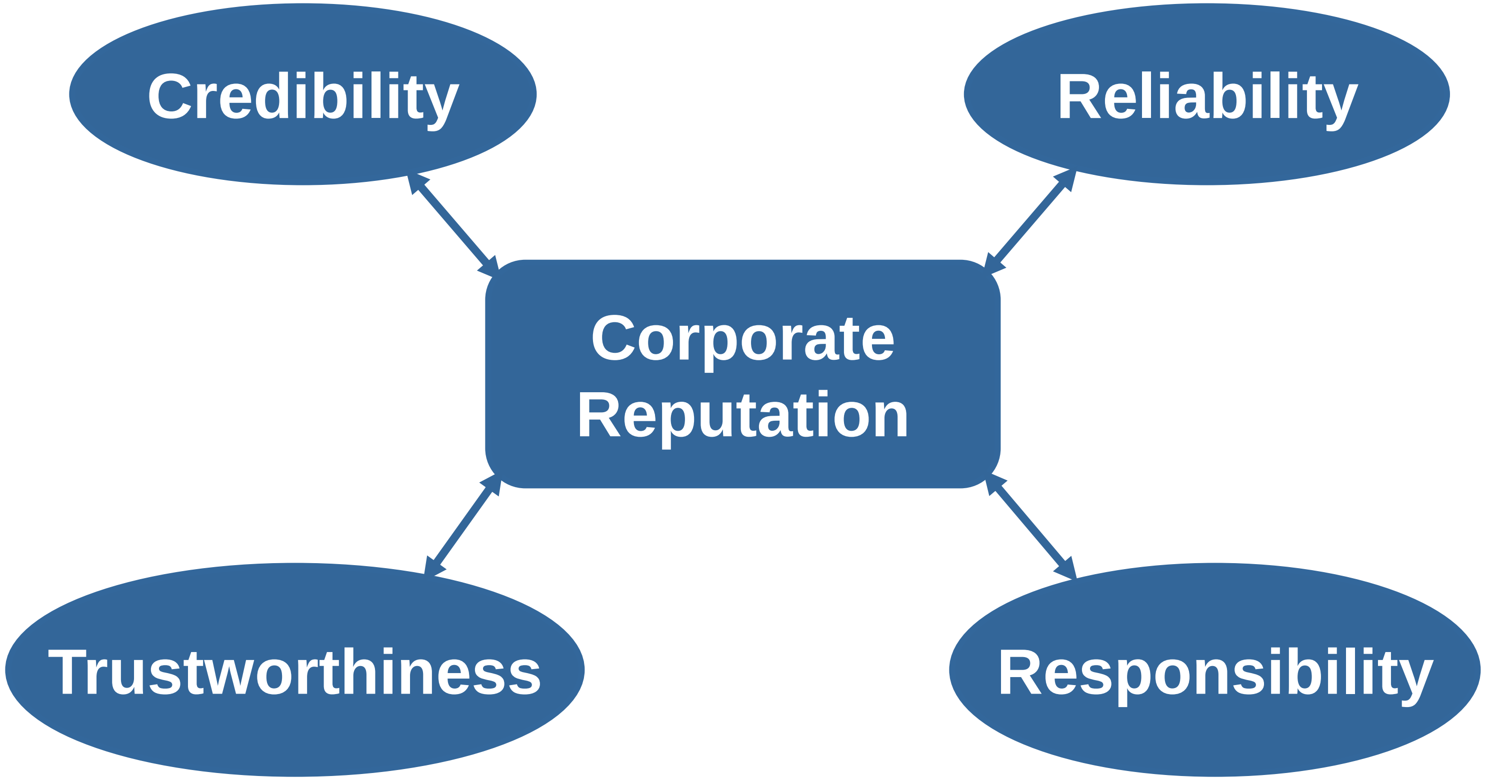
Hypernorms involve the demonstration of the following basic values:

Honesty	Fairness
Compassion	Integrity
Predictability	Responsibility

Source: R. Berenbeim, Director, Working Group on Global Ethics Principles, The Conference Board, Inc., 1999

FIGURE 1.3

DETERMINANTS OF REPUTATION



Fombrun, p. 72

TABLE 1.3

RISK EVENTS CAUSING DROPS OF OVER 25% SHARE VALUE, PERCENTAGE OF *FORTUNE 1000* COMPANIES, 1993-1998

Strategic (58%)	Customer demand shortfall (24%) Competitive pressure (12%) M & A Integration problems (7%) Misaligned products (6%) Others (9%)
Operational (31%)	Cost overruns (11%) Accounting irregularities (7%) Management ineffectiveness (7%) Supply chain pressures (6%)
Financial (6%)	Foreign, macro-economic, interest rates
Hazard and other (5%)	Lawsuits, natural disasters

Source: Mercer Management Consulting/Institute of Internal Auditors, 2001.

TABLE 1.4

IMPORTANT RISK MANAGEMENT TERMS

Risk is the chance of something happening that will have an impact on objectives.

Risk Management includes the culture, processes, and structures that are directed towards the effective management of potential opportunities and adverse effects.

Risk Management Process includes the systematic application of management policies, procedures, and practices to the tasks of establishing the context, identifying, analyzing, assessing, managing, monitoring, and communicating risk.

Source: *Managing Risk in the New Economy,* AICPA & CICA, 2001, p. 4

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TABLE 1.5

ETHICS RISKS—A REPRESENTATIVE LIST

STAKEHOLDER EXPECTATIONS NOT MET	ETHICS RISK
Shareholders	
Stealing, misuse of funds or assets	Honesty, integrity
Conflict of interests with officers	Predictability, responsibility
Performance level	Responsibility, honesty
Reporting transparency, accuracy	Honesty, integrity
Employees	
Safety	Fairness
Diversity	Fairness
Child and/or sweatshop labor	Compassion, fairness
Customers	
Safety	Fairness
Performance	Fairness, integrity
Environmentalists	
Pollution	Integrity, responsibility

TABLE 1.6

STAKEHOLDER REPORT TOPICS

Health and Safety	Environmental Performance/Impact
Sustainability	Corporate Social Responsibility (CSR)
Philanthropy	Workplace Responsibility

Betaseron (A) Case

Three Problems

- Pricing
- Distribution
- Supply

Betaseron (A) Case

Drug thought to arrest MS

Market – 300,000 33% in best-suited group

Early FDA Approval, so not enough production ready

How will we allocate scarce production?

Year	Supply	Need	Choose Price p.a.	Means Allocation By
1	20000	?	$50,000	Market
2	40000		$10,000	Play God
3	60000		?	?

Betaseron (A) Case

What did we learn?

- Reputation
- Expectations
- Stakeholder impact
- Importance of ethics
- Role of corporation
- Ethics & Profit
- Short run *vs.* Long run
- Ethics & Governance

A Stakeholder Is...

- Anyone who is affected by or can affect the objectives of the organization

(Freeman, 1984)

- An organization must have

the support of its *primary stakeholders*,

to optimally achieve its strategic objectives

Governance – Definition

Those mechanisms, processes and relations by which corporations are controlled and directed.

Shailer, Greg. *An Introduction to Corporate Governance in Australia*, Pearson Education Australia, Sydney, 2004

Governance Theories:
What Drives Action?

- Agency Theory – individuals attempt to opportunistically maximize his/her own personal gain
- Stewardship Theory – management wants to do a good job through performance of their duties
- Resource Based Theory – a firm's internal environment, including its resources and capabilities are most important in determining strategy and action
- Shareholder Theory – shareholders' interest are the most important – shareholder primacy, wealth maximization
- Stakeholder Theory – stakeholders' interests are as important as profit. Quality of life, manger satisfaction and respect for society and the environment are also relevant.

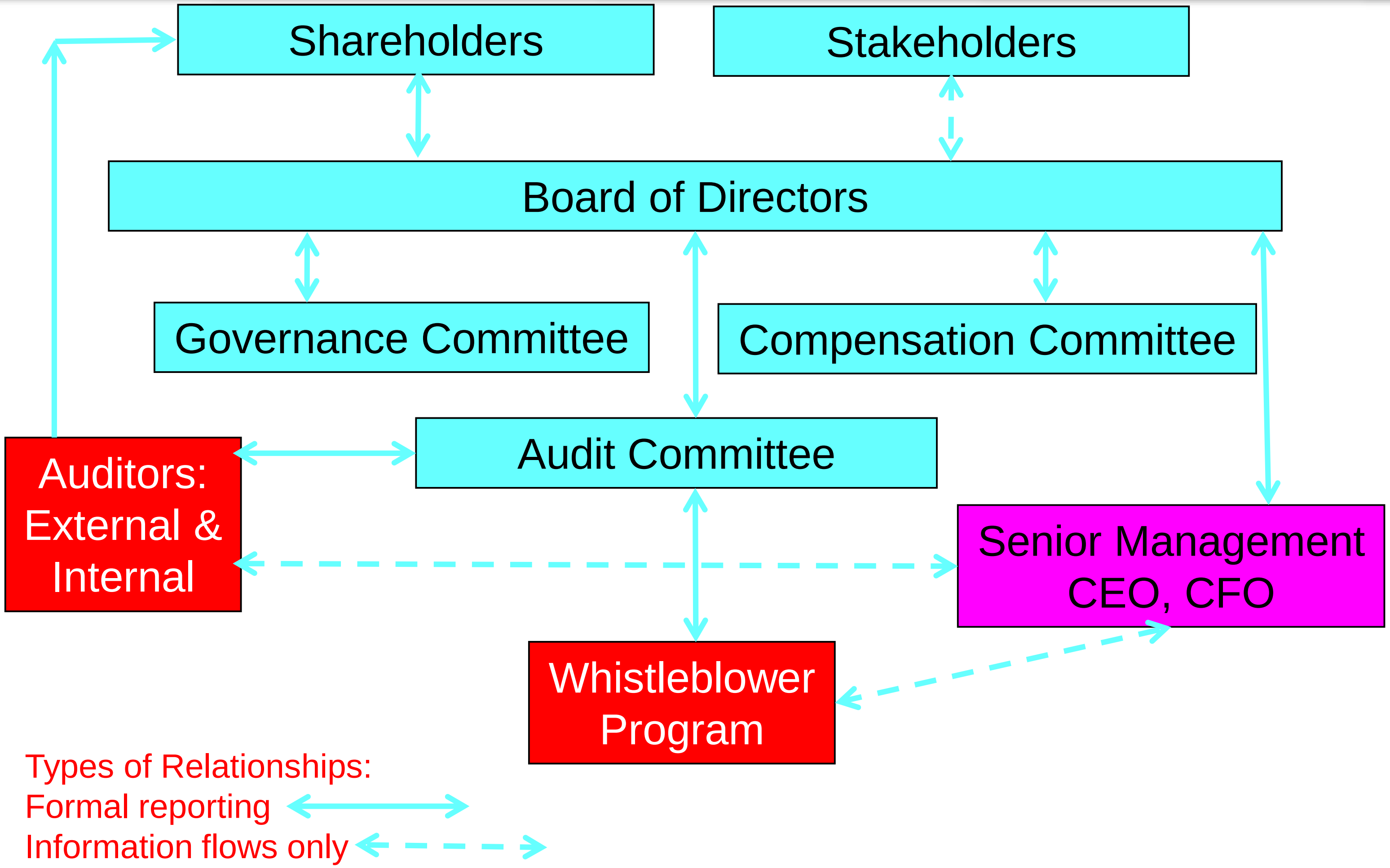
Which one(s) do you think are really at work?

What impact do they have on governance measures?

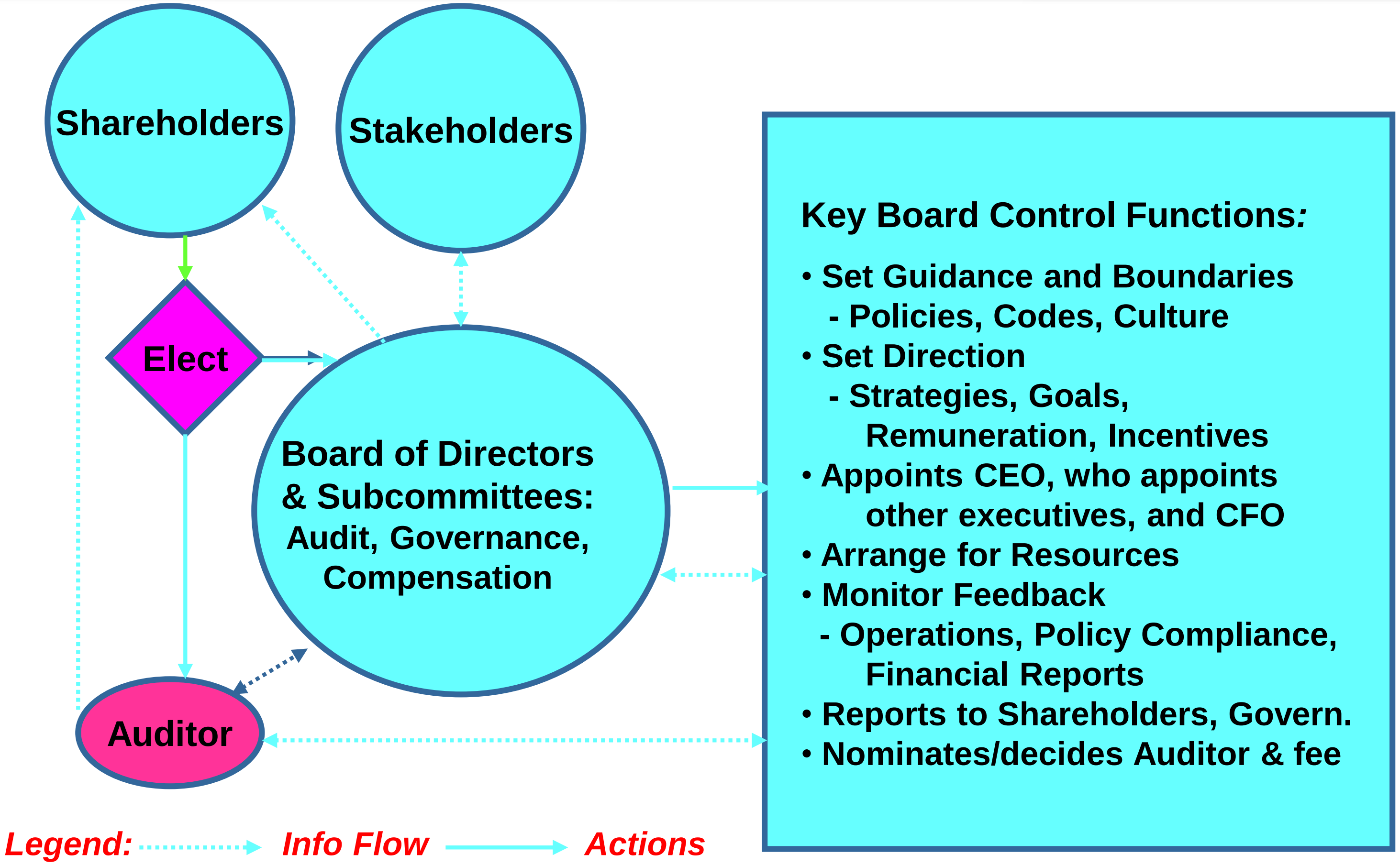
Ownership Structures, Documents & Processes

- A Basic Company Structure
  - Articles of Incorporation, or the *Corporations Act*
    - Mandate, board of directors: number, voting rules, powers, officers; rights and duties (banking, annual shareholders meeting; financial reports to shareholders; other shareholders' rights, audit, security of assets …)
  - Equity (Ownership)
    - Common shares – voting on directors, dividends
    - Preferred shares – preference re. dividends, voting only if …
    - Shares of different classes (A, B, C …) [Multiple voting rights]
  - Debt (Borrowing from Lenders)
    - Debentures - unsecured
    - Bonds – secured by …

Figure 5-1: Governance Structures & Relationships



CORPORATE GOVERNANCE FRAMEWORK



Board Responsibility for Corporate Actions:
Legally to shareholders - Strategically to other stakeholders

Table 5-1: Directors' Functional Responsibilities

- Safeguard the interests of the company's shareholders
- Review overall business strategy, and in some jurisdictions take stakeholder interests into account
- Select and compensate the company's senior executives
- Evaluate internal controls and external auditor, and recommend the company's outside auditor for election by the shareholders
- Oversee the company's financial statements, and recommend them to the board for transmission to the shareholders
- Monitor overall company performance

Adapted from the Report on The Role of The Board of Directors in the Collapse of Enron,
U.S. Senate Permanent Subcommittee on Investigations, July 8, 2002

- Ensure:
  - An effective system of internal controls and internal audit
  - An effective whistleblower system reporting to the audit committee
  - Effectiveness of the company's risk management program
  - Efficacy of the company's ethical corporate culture

SOX and Recent Governance Expectations

Legal accountability to shareholders; strategic accountability also to stakeholders

Table 5-2: Directors' Behavioral Expectations

Fiduciary Duties

- Acting in the best interest of the company (shareholders & stakeholders)
- Loyalty to be demonstrated by independent judgment.
- Actions to be in good faith, obedient to the interests of all
- Actions demonstrate due care, diligence, and skill (i.e. financial literacy)

Adapted from Statement of Corporate Governance, The Business Roundtable (September 1997)

Conflicts

- Require disclosure, and actions to manage effectively

Liability Issues

- Business Judgment Rule
- Oppression remedy
- Personal liability for Tort Claims

Responsibilities of Directors in Canada, Torys LLP, 2009

Directors’ Legal Framework

- Personal liability for own acts, and for acts of company
- Business Law – incorporation, governance & business conduct
- Other statutes & regulations: securities, labour, occupational health & safety, environmental protection, taxation, pensions, bankruptcy & insolvency
- Directors’ Duties
- Business Judgment Rule
- Oppression Remedy
- Personal Liability for Tort Claims

Directors' Duties

- Duty of Loyalty & Good Faith
  - Act in the best interests of the corporation
  - Recognize and deal with conflicts of interest
  - Not divulge confidential information received as a director, nor use it for personal advantage
  - May not divert opportunities for self-dealing, other co's
- Conflict of Interest
  - Process – declare, refrain from voting, no appearance of conflict to taint co. decisions, resign
- Duty of Care, Diligence & Skill that a reasonably prudent person would exercise in comparable circumstances
  - Informed judgements, consideration of relevant info, active role in key matters

Business Judgment Rule

- Courts are reluctant to second-guess reasonable business judgements made by unconflicted directors. Per the Supreme Court of Canada (in *Peoples Department Stores Inc. (Trustee of) v. Wise*)

> Directors and officers will not be held to be in breach of the duty of care under s. 122(1)(b) of the CBCA if they act prudently and on a reasonably informed basis. The decisions they make must be reasonable business decisions in light of all the circumstances about which the directors or officers knew or ought to have known. In determining whether directors have acted in a manner that breached the duty of care, it is worth repeating that perfection is not demanded. Courts are ill-suited and should be reluctant to second-guess the application of business expertise to the considerations that are involved in corporate decision making, but they are capable, on the facts of any case, of determining whether an appropriate degree of prudence and diligence was brought to bear in reaching what is claimed to be a reasonable business decision at the time it was made.

Oppression Remedy

- If shareholders believe they have been treated oppressively or unfairly by the decisions of directors, they can apply to the courts for financial compensation or other sanctions citing the need for an oppression remedy
- If directors have not been self-dealing or appropriating opportunities, they can usually defend personal attacks under the Business Judgement Rule
- Reservation – minority interest shareholders are often unable to get the treatment they would like – they are in the rumble seat.

Personal Liability for Tort Claims

- If a director committed a tortious act (one that injures people or property) on a third party, they cannot escape personal liability because they did it on behalf of a corporation when performing their corporate duties.

- A tort can be intentional or unintentional, where unintentional includes negligence or negligent misrepresentation due to lack of the duty of care or foreseeability.

Key Lessons from Recent Disasters

- Mindset problems
  - Rationalization – Did nothing wrong, no victim
  - Values deficiency – fairness, integrity, virtues expected
  - Priorities – self, profit, legality, … others?
- Governance flaws
  - No whistleblower encouragement program
  - No checks on opportunism – just too much trust/neglect
- Self-interest & regulation are not enough
  - Need ethical corporate culture/culture of integrity
- Reputation lost

Kardell Paper

- What is the scenario?
- Who are Kardell's stakeholders?
- Are their claims equally important?
- What factors would you suggest the Board consider in its decision?
- Did the Board make any mistakes? Why?
- Apply moral imagination for a better decision?

Oversight of Important Processes

Why for each?

- Risk management
- Financial integrity
- Corporate culture, compliance
- Feedback programs including whistleblowing
- Cybersecurity

Compliance and control: company culture, policies, compliance mechanisms

My concern is that regulators and boards of directors think 'they can do the governance process and control'.

Governance does not work because of rules. Governance works because of culture and values through all levels of a company. Regulators and boards of directors setting down governance rules is prone to problems. I think that management must lead in governance as they have the most direct impact on company culture and values. R.H. Kidd, August 2014

- Why is this?

Oversight of strategic planning, and management activities

- Directors must set or approve company goals, which come from strategic plans, so they should make sure the strategic planning process is sound.
- Management activities should be aimed at achieving company plans or goals, so they need to be monitored.

Oversight of shareholder & stakeholder relations

- What does this mean?
- What is involved? List.

- Are the objectives the same for shareholder relations and stakeholder relations?
- Where does Corporate Social Responsibility (CSR) fit?