Business ethics begin in the boardroom

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Abstract

Recent business scandals and corporate collapses have brought calls for better business ethics, more training in ethics, and further regulation. But ethics in business are not a matter of corporate citizenship, social responsibility, or sustainability: they are intrinsically part of every business decision from the boardroom, throughout management, to basic operations. Business ethics begin in the boardroom and reflect directors' attitudes to risk. Recognizing and managing that risk are fundamental to every board's corporate governance responsibilities. Trust in business will not be rebuilt by more rules, regulations, or corporate governance codes, but as directors create cultures that recognize and handle ethical risk.

Recent years have seen a spate of business crises and corporate collapses around the world. The actions of key executives and the attitudes of their directors have come under the public spotlight. Fraudulent management in Australia's HIH Insurance, corruption in Italy's Parmalat, allegations of bribery against BAE Systems and Rolls Royce, the world-wide collapse of auditors Arthur Andersen, the rigging of interest rates by bankers provide ready examples.

Such cases have raised concerns about business ethics, which are now widespread and serious. The media focus on companies' social responsibilities, relations with their stakeholders, and call more ethical business. Regulators, commentators, and business school professors push for better corporate citizenship. Recently, green credentials and sustainability have been added to the agenda.

But business ethics are not an optional exercise in corporate citizenship, they are fundamental to the governance and management of every organization. Decisions at every level in a company have ethical implications – strategically in the board room, managerially throughout the organization, and operationally in each of its activities. Ethics reflect behaviour *in* business and the behaviour *of* business. In business, ethics involve the recognition and management of risk.

Inevitably, business involves risk. Excessive risk taking by financial institutions sparked the global economic crisis. The board of directors and top management are responsible for establishing their company's risk profile, determining the level of risk acceptable to them. Some companies accept higher levels of risk than others.

There are only four possible responses to business risk:

1. *Avoid the risk.* Do not take the planned action. Abandon a proposed project because the risk is felt to be too great.

2. *Mitigate the risk.* Make capital investments or incur on-going expenditure to reduce the exposure to risk; for example, by investing in stand-by equipment, duplicating critical components, or training staff. Policies can also be adopted that reduce risk, such as requiring top executives to travel separately, or never building in hurricane-prone locations.

3. *Transfer the risk.* Spread the exposure with other parties by insuring against the risk, transferring elements of risk to the insurance company, or hedging the risk through long-term contracts or derivative instruments that transfer risk to third parties.

4. *Take the risk.* In other words, accept it as the cost of doing business.

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With risks that arise from moral hazards that is ethical risks, mitigating or transferring the risk are seldom viable options. Recognizing and accepting a risk may be the only alternative to abandoning that opportunity. Consequently, the consideration of exposure to ethical risk needs to be part of every board's strategy formulation, and enshrined in corporate policy and enterprise risk management. With moral dilemmas in business it is seldom a matter that actions are good or bad, right or wrong, but what's the best choice, the most appropriate decision, for the company and those affected by its actions.

Most boards insist that their company should not break the laws of any jurisdiction in which they operate. Unfortunately such an attitude does not address ethical questions that can arise in other countries. Major companies, including Google, Amazon, and Microsoft, have been criticised for 'aggressive tax avoidance' when they manoeuvred funds through tax havens to reduce global taxation, even though their actions were perfectly legal. Alleged excessive top management remuneration has also been a source of concern, particularly to increasingly vocal shareholder activists.

Business ethics have not traditionally been thought of as part of corporate governance. They have been seen (and researched and taught) as separate subjects. Corporate governance is concerned with the way companies use their power and the way power is exercised over them. The use, and sometimes the abuse, of that power can raise ethical issues.

Enron, the giant American energy business, failed dramatically. Some of its directors went to jail. Yet that company appeared to meet the tenets of good corporate governance: the board had distinguished independent directors; there were audit, nomination, and remuneration committees; and the role of board chairman was separate from that of the chief executive, unusual for large American corporations at the time. What the board failed to realize was that the company's risk profile had changed dramatically when it moved from generating energy to trading in energy futures. It had moved from being a producer of energy to a financial institution. Moreover, the directors failed to see the moral hazard in some of the accounting methods that management had adopted.

Despite written policies on corporate social responsibility and sustainability, the oil company BP faced a disaster in the Gulf of Mexico when their Deepwater Horizon oil-rig exploded and sank. The board had failed to recognize or had accepted this exposure to risk in their operations. Further, following the disaster top management were slow to respond to public and political concerns, failing to realize the company's exposure to reputational damage. The company lost over half its share value.

Critics of business behaviour point to fraud, bribery and corruption. They allege price-rigging, pollution, and counterfeiting. They claim arrogance, greed, and abuse of power by those at the top of companies. Trust in business has been eroded. For some business ethics has become an oxymoron, as they cite corporate avarice, disparity of wealth, and director rewards that are not reflected in corporate performance.

Yet business exists by satisfying customers, creating employment, and generating wealth. Business provides the taxes that society needs to function. Many companies accept a social responsibility to be sound corporate citizens. They recognize that they have a duty to respect the interest of all the stakeholders who might be affected by their actions. Many also seek a sustainable, environmentally friendly approach to their operations. To those who doubt whether modern business can be trusted, they point out that business dealings and the very concept of the limited-liability company are based on trust. Trust in business will not be rebuilt by more rules, regulations, or corporate governance codes, but as directors create cultures that recognize and handle ethical risk.

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These few thoughts have been adapted from our new book, (Business Ethics) which is a primer on ethics in business not on moral philosophy. It considers what business ethics are, why they are important, and offers practical approaches on developing a successful corporate ethics culture. Inevitably, this reflects what goes on in and around the board room.

Ultimately, the board of directors and top management are responsible for the ethical behaviour of their enterprise. Directors set the standards for their organization, provide the corporate conscience, fashion its culture, determine the risks to be taken, and set the ethical climate. They generate the value system for the organization. Business ethics begin in the board room