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CORPORATE GOVERNANCE & ETHICS: HOW UNETHICAL DECISION-MAKING COULD AFFECT WORLD'S ECONOMY

Abstract. Why managers behave unethically? Why boards did not control CEOs and limit their power? How government can regulate such unethical violations by law and how to avoid next crisis of unethical decision-making? This paper is going to address and try to answer these questions along with the analysis of some unethical decisions that lead to last crisis and finally provide some recommendations how to avoid this in the future.
Keywords: corporate governance, ethics, decision-making.

Introduction

Last financial crisis showed up issues related to ethics in finance. Most of the people are now thought that the main crisis driven force was lack of government and corporate regulation on ethics. The most hot, first page topics in newspapers and internet articles were consist of words "Bonuses", "Wall Street", "Ratings" and "Compensation". These led to a big number of recent investigations and scandals. Not all of them are disclosed yet, too many questions still exist. Why managers behave unethically? Why boards did not control CEOs and limit their power? How government can regulate such unethical violations by law and how to avoid next crisis of unethical decision-making? This paper is going to address and try to answer these questions along with the analysis of some unethical decisions that lead to last crisis and finally provide some recommendations how to avoid this in the future.

First part of the paper is belong to pre-crisis government inputs on ethics – Sarbanes-Oxley Act, following with major issues in corporate governance and ethics. Next part is belonging to credit rating agencies (CRA) as essential part of finance industry today, and many ethical questions around CRAs. We will then present ethical issues raised as the consequences of principal-agent problem and continue to evaluate ethical impact in government decision making.

Last decade start with dot-com crashes, continue with Enron bankruptcy and finished with 2008 crisis (Ryan, Buchholtz & Kolb, 2010). All of these events greatly affect stock market and economy; moreover, they potentially decrease trust of investors to companies and stock market itself. More and more investors change their minds and switch from stock markets to other financial instruments, this situation caused increase in cost of capital to companies, because of high risk. Some of the companies go bankrupt due to inability of been profitable under high cost of capital, firing people and so on. Such situation is beneficial to neither shareholders nor government. Only one outcome was acceptable in such situation – strict government regulation of companies. Especially in such areas as corporate ethics, where decision-making process could greatly affect company itself and lead to bankruptcy, including employee firing and lack of taxation from such companies.

Sarbanes-Oxley Act

First step was made by US government in 2002 when Sarbanes-Oxley Act (SOX) was created, presented, published and forced to be followed by any business in United States. SOX was mainly created in order to eliminate laws misreading that Enron used heavily prior to bankruptcy. This act changed accounting procedures, internal control in organization over decision making and financial statements preparation, introducing ethical responsibility of CEOs over the financial statements presented to public.

Main reason of Enron, WorldCom and another bankruptcies and further scandals was the company's ability to play with numbers in accounting, approach called "creative accounting". Main principle is to put off the balance sheet great amounts of debt or any other obligations, which were able to negatively affect share price, credit ratings, investors relationship, etc. Sarbanes-Oxley Act now restricts all of these possibilities. Section 401 directly belongs to disclosures in periodic reports and strictly require reflect any off balance sheet transactions in quarterly statements.

Prior to Sarbanes-Oxley Act no one from top executives have obligation to sign financial reports before publishing. Now, section 302 of SOX strictly requires top executives such as executive and financial officers to sign reports individually in order to confirm that statements reflect accurate, up to date and trustful information. This means that top management officers are now personally responsible for any numbers in company's financial statements. This section completely eliminates "creative accounting", because no one want to be personally responsible for errors or mistrustful information. Moreover, if mistrustful information will be found after official publishing it could lead to fine or lawsuit against executives if statements changed intentionally and this is not a typo. None of the executives wants to be fined, suited or even fired without an ability to find future job. Section 302 greatly affect responsibility of executives for financial statements and completely eliminate creative accounting or any other approaches to make statements look more attractive.

Issues in Corporate Government and Ethics

In their research Ryan et al. (2010) discover some more factors that recognized as issues of corporate governance. The most criticized issues are – pluralist voting model, inability to nominate directors by minority of shareholders and CEO's duality position as executive officer and member of director.

Large investors and especially institutional argue to change rule of election of board members. They want to change pluralist voting approach to majority voting. Pluralist voting include three options in ballot – "yes", "no" and "withhold" and winner recognized with any number of "yes"; however, majority voting approach include only two voting options – "yes" or "no" and winner recognized with majority of "yes". Difference between two approaches is substantial and sometimes helps directors retain or obtain seats in board, even while most voted "withhold" (Ryan et al., 2010).

Another issue is inability to nominate directors by minority of shareholders. Minority investors argue that ability to nominate board members could reduce the entrenchment of management-co-opted directors (Ryan et al., 2010). From the one point of view, large shareholders are only ones who are nominate directors for board, but another point of view assumes that board sometimes need fresh members. However, new board members could decrease efficiency of the board, due to lack of experience if company is new for them.

CEO duality is the situation when Chief Executive Officer at the same time serving as Chairman. Shareholders argue that CEO duality is inappropriate for not family owned business. Such situation has more risks than advantages. Chairman and board should approve strategic decisions and CEO should execute and follow them, but in case if Chairman and CEO is the same person – conflict of interests arise. It is impossible for CEO gives orders and controls himself as Chairman.

After too many campaigns, majority voting was introduced voluntarily by companies and according to Ryan et al. (2010) more than 66 percent of S&P500 firms now have majority voting. Delaware was the first state to introduce ability for minority shareholders (1% and more) to nominate directors to boards, then SEC propose such rule in 2009 (Ryan et al., 2010). CEO duality is still unclear and deserves further examination and discussion.

Credit Rating Agencies Ethics

Credit Rating Agencies are independent organizations in US and throughout the world. Primary business of these organizations is to study, analyze and evaluate public companies and finally assign rating that these companies deserve. A lot of companies and organizations use such ratings in order not to make due diligence or new evaluations by their selves, but simply use ratings. Even more, some financial organizations are using ratings published by such well known ratings agencies like Standard and Poors, Moody's and Fitch; therefore, credit rating agencies should be as strict as possible during evaluation process and publish only trustful and error free reports.

According to Scalet and Kelly (2012), major criticism of credit rating agencies during last crisis was due to high meltdown in highly rated bonds and other securities that subsequently defaulted. There a lot of AAA (highest possible rate) corporate bonds, which are defaulted during 2008. This fact raises too many questions regarding future trust to credit rating agencies and argues for government regulation or supervision among credit rating agencies industry.

Taking into account the fact that even highly rated companies defaulted on its liabilities during last crisis we could argue that credit rating agencies are also responsible for huge investors' losses during crisis. This fact lead us to conclusion that credit rating companies did poor job while evaluating companies in pre-crisis time, we also can say that it was unethical in relation to financial companies and individual investors who used publicly available ratings for investing purposes.

During post-crisis investigations, many pitfalls became apparent regarding financial system and rating reports. Evermore, conflict of interests appeared. Credit rating agencies has two primary source of income: paid by a company in order to be examined, evaluated and receive publicly available rating then reevaluated during time; paid by a company in exchange of consulting how new issuance of securities should be packaged in order to receive highest possible rating and attract more investors (Scalet &Kelly, 2012). We can argue that both of the sources of income could cause conflict of interests between issuer's company, credit rating agency and end-users of rating reports, such as financial institution or individual investor. In first case, if company pay for rating then it could anticipate to be highly evaluated. Credit rating agency in this case paid by a company, not an end-user of information, so it could be biased to company, but should take neutral position in any case like an arbitrator. Second case could also lead credit rating companies to be biased by the fact that they in exchange for money helping companies with new issuance of securities in order to value them more highly. This fact is also shifting credit rating agency from neutral position to the company's side putting it the opposite side of investor's interests.

According to Graafland and Ven (2011), competition between rating agencies through rating shopping resulted in rating inflation. This fact directly leads to and rise ethical issues over credit rating agencies. The purpose of credit rating agency is to provide independent rating for company or security itself, but as any commercial company, CRA's main purpose of business is to maximize shareholders' wealth. As authors point out, in exchange for additional profit credit rating agencies were ready to inflate rating. This is critical ethical issue. This fact is unethical anyway and should be strictly reevaluated by the government. Further research in this field should point out that government regulation is quite necessarily here.

Speaking in relation to ethics, we should believe that credit rating companies have a chance to be biased in their day to day operations and be greatly affected by the fact that they directly receiving money from the companies they evaluate. Having fresh reminiscence of last crisis, government and other agencies should sit down and decide how to switch this direct interaction between company's and credit rating agencies. Notwithstanding, its current regulation, credit rating companies should be as neutral as possible. One approach to split direct money interaction between credit rating agencies and companies is to establish public non-profit organization that will work as intermediary. Big case here is anonymity from the one side and issue from the other side. Credit rating agencies will be unable to get any information regarding the customer name, whether it company itself asking for evaluation of rating or any financial institution is interested in company's rating or re-evaluation.

Credit rating agencies evaluate not only corporate securities, but also sovereign debt; therefore, question regarding ethics in credit reports is important, complex and need to be discussed at the top government level. Unethical behavior of credit rating agencies could seriously hurt not only standalone company, but also country's and world's economy as well.

Ethical Issues around CEOs

Another hot newspapers' topic during last crisis was belong to CEO's compensation. During many investigations, it was disclosed that many companies, which request government support, including giants, continue to pay huge bonuses to Chief Executives. Many investors, government agencies and politicians point out that it was unethical to continue pay so huge salaries and bonuses, especially if these CEOs led company to pre-bankruptcy condition and receive government support in the form of cheap funds or any other guarantees. Politicians argue that these companies should be as more effective as possible and as ever as they were.

Principal-agent issue or even problem arises in companies and corporations, where management is consist of non-shareholders or shareholders with small shares. Problems appeared due to poor correlation between company efficiency or profitability and CEO's compensation. According to Dunham and Washer (2012), agency problem between management and shareholders decreases as the level of stock ownership held by management increases.

Principal-agent problem always should be evaluated as ethical or unethical issue. Questions regarding ethics should be asked to board or shareholders and directly to executive officers. From the one point of view huge bonuses is the responsibility of board and shareholders, because they are responsible for compensation to CEO. From the other side, CEO himself could require too much compensation and extort from the board or shareholders in exchange of profitability or stability during tough times. All of these issues are subjects of ethics discussion.

We can continue our ethical discussion in relation to CEO by taking in account last crisis scenario. Many CEOs were blamed for excessive risk taking as one of the crisis cause. Excessive risk taking from the one point of view is lead to high profitability, but from another to critical finance situation of even bankruptcy during weak economy or recession. Most of the investment decisions are made by CEOs, so CEO is the only one, who is responsible for consequences positive or negative. In companies, where CEO is not major shareholder, CEO is always in hard position and should decide which decision to make. He is acting always on behalf of shareholders, but should choose among his own interests or interests of company's shareholders. It is strictly prohibited and unethical for CEO to put his own interests above shareholders. Unfortunately, sometimes it happens. When CEO compensation is directly correlated to company's profitability or even cash flow, CEO is more concerned regarding own compensation than risk for shareholders. In such cases, CEO is more willing to undertake those project that will increase his compensation, but could too risky for shareholders and even if profitable, but only in the short run.

High risk taking is not only CEO's wish, it happens that board push CEO for maximizing profitability with high risk taking as only solution. In such cases, CEO must decide to take high risk, having no other options. Both cases are unethical form the corporate ethics point of view. Both situations finally could lead to bankruptcy and no one will be the winner.

To prevent or eliminate unethical behavior at all, companies and government should take some agreed actions. Government agencies cannot directly give orders to private companies, so some mechanisms of control should introduced through SEC or other government agencies.

Ethics Aspect and Government

As Graafland and Ven (2011) states in their "The Credit Crisis and the Moral Responsibility of Professionals in Finance" paper, government institutions have failed before last crisis in three respects. First, continuous support of credit expansion in real estate market. Second, too much liquidity with cheap money; and third, lack of supervision in financial markets.

Analyzing each aspect individually, we discover that ethical issues are involved. Continuous government support of credit expansion in real estate market is good from the one side and bad from another. It is positive for US economy – new workplaces, new taxes, and new investments; however, from the other side too much government support could hurt if too many risks are involved. According to Graafland and Ven (2011), risk managers send warning signal on time, but further government official ignore it, because of certain goals are not fulfilled. Ethical aspect appeared here, government official, responsible to shutdown excessive support when necessary, just ignore warning. He was biased by the fact that from the one side he is the only responsible to shutdown support program one risks are high, but from the other side he could be punished due to lack of meeting established goals. Analyzing this fact from the point of ethics view we should point out that such situations occur frequently. Persons in charge are more willing to be afraid of punishment and therefore, prefer not to undertake such actions. Having great negative experience including recent crises, government should analyze such situations, change roles and process involved in decision making and try to create a way, when only ethical decisions will be made.

More and more questions raised around the question should US government give a hand of support to Lehman Brothers corporation or not? Whether it is ethical to leave them go over bankruptcy or use taxpayers' money to save one more private company that have made many unethical decisions? This time US government made strong ethical decision not to allocate any support twill have has cascade effect of other weak corporations' bankruptcy. Why government itself should make ethical decision if company fails to be ethical at all? Many CEOs and companies after that conclude that if you are acting unethical, the same relationship you should anticipate from internal and external environment to yourself. We believe that this fact will be kept in mind for a long period of time, and be crucial when company willing to behave unethically.

Conclusion

Throughout the paper, we address ethical questions in decision-making process at present time. We prove that unethical behavior and decision making at corporate and even on government level could led to negative consequences. We also present some situations when unethical decisions hurt not only standalone companies, but also whole industry, and even world economy. We thought that ethics is sufficient part of corporate governance in the modern world. This field deserves to be on the top of studies for young managers, presenting huge losses as a consequence of one small unethical decision.

Notwithstanding its great impact of unethical decision-making, we believe that positive conclusions are made and lessons are learned. We believe that future government regulation of financial markets, especially credit rating agencies and CEO's risk taking will have positive impact for economy and investors' safety.

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