

**It has been said that governance failures usually happen within the subsidiary structure of a large business, but all governance focus tends to be at the main board level. Is the focus on the right area and, if not, what improvements could be made?**

Just days ago, 135 companies from 23 countries spanning 57 industries were honoured for making the list of World's Most Ethical Companies according to the Ethisphere Institute.<sup>1</sup> These businesses accounted for approximately US\$5.16 trillion in market capital, US\$2.08 trillion in annual revenues and touched 6.28 million employees across the globe<sup>2</sup> and highlight that critical to ensuring governance success is having and complying with the rules of ethical conduct. Regardless of country, industry or scale of business, this essay will argue that governance failures – be it within the subsidiary structure of a large business or at the parent company – are a direct result of the lack of an effective ethical framework pervading business operations. This essay will illustrate that what occurs below board level and within the subsidiaries<sup>3</sup> are equally important as what happens at board level. An ethical framework constitutes the epicentre of successful business governance, as it goes beyond the gaps left by legal provisions, which only ethics can fill.

Businesses can no longer underestimate the reputational and financial risks that subsidiaries bring<sup>4</sup> as they ultimately have responsibility for financial losses and suffer reputational damage from governance failures at subsidiaries. Bhopal was a tragic wake-up call to companies to pay more attention to subsidiaries<sup>5</sup> and not only to pay attention after a scandal or failure. Barings Bank collapsed due to the unethical behaviour at its Singapore subsidiary.<sup>6</sup> The losses at Allied Irish Banks plc took place in its American subsidiary, Allfirst Financial Inc.

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<sup>1</sup> The Ethisphere Institute is the global leader in defining and advancing the standards of ethical business practices that fuel corporate character, marketplace trust and business success. It has deep expertise in measuring and defining core ethics standards using data-driven insights from its Ethics Quotient, and works with the world's largest companies to enhance culture capital with the insights from its culture assessment data set, which is grounded in its 8 Pillars of Ethical Culture. It honors superior achievement through its World's Most Ethical Companies recognition program and provides a community of industry experts with the Business Ethics Leadership Alliance (BELA). The Ethisphere Institute website, [worldsmoethicalcompanies.com](http://worldsmoethicalcompanies.com), accessed on 9 march, 2018.

<sup>2</sup> Ibid.

<sup>3</sup> Subsidiaries can include wholly-owned and partially-owned subsidiaries, joint ventures, associated companies, special purpose entities or vehicles, trusts and other types of entities. A strict definition of a subsidiary refers to a legal entity which is majority-controlled by a parent. However, many group entities are not majority-controlled by a parent, but the parent has joint control (as in the case of a joint venture) or only significant influence (as in the case of an associate), Governance of Company Groups by Mak Yuen Teen & Chris Bennett, The Iclif, Leadership & Governance Centre, CPA, Australia, 2014.

<sup>4</sup> *Subsidiary Governance: The Elephant in the Room*, ICSA, R&C Risk and Compliance, April-June, 2017 Issue.

<sup>5</sup> ICMR, IBS Center for Management Research, accessed on 9 March, 2018 at

[http://www.icmrindia.org/http://www.ibscdc.org/Case\\_Studies/Business%20Ethics/Business%20Ethics](http://www.icmrindia.org/http://www.ibscdc.org/Case_Studies/Business%20Ethics/Business%20Ethics).

<sup>6</sup> *The Collapse of Barings*, <http://www.worldcat.org/title/collapse-of-barings/oclc/35658104> accessed on 9 March, 2018. The Manager eventually pleaded guilty to two counts of deceiving bank auditors, including forging documents and cheating the SIMEX.

The BP Deepwater disaster and the News Corporation phone hacking scandal, both occurred in group entities with their own boards.<sup>7</sup> With businesses growing apace on all fronts – global, regional and local, having a robust ethical framework in place is more essential than ever.

Businesses are under pressure to remain profitable and to show a good return to shareholders. Often this can result in unethical decisions being made. Ethics makes no concessions for the real or imagined necessities of making a profit.<sup>8</sup> One of the basic principles of ethical behaviour in business is having genuine books of accounts prepared.<sup>9</sup> The failure of Enron was not due to an ‘audit failure’ as advanced, instead it seems more accurate to state that it was an ‘ethics failure’ of immense proportion. Enron chose to inflate earnings and hide debts in special purpose vehicles where the culture allowed secrecy, rule-breaking and fraud. Enron’s downfall and the imprisonment of the CEO is one of the most widely reported ethics violations of all time. Ethics must begin at the top, it is a leadership issue and the CEO must set the example.<sup>10</sup> How ironic indeed, that Enron was named as “America’s Most Innovative Company” by Fortune Magazine for six years in a row prior to the scandal. In similar vein, the CEO of Worldcom made outright fraudulent accounting entries until the fraud was discovered. The bankruptcy examiner’s report on the collapse of Lehman Brothers found credible evidence that the CEO, who was later convicted, had approved misleading statements and used accounting gimmicks to hide the truth. While some postulate that these executives suffered from Hubris Syndrome,<sup>11</sup> it seems more apt to conclude that they suffered from Unethical Syndrome.

Corporate governance failures are not confined to any country, industry or sector. In 2017, for the fifth year in a row, the finance, retail and technology sectors continue to register the highest number of ethical lapses according to IBE.<sup>12</sup> These lapses can also be seen in banking, general retailers, technology, the gig economy,<sup>13</sup> leisure and travel, mining and extractive, food and beverage, support and professional services, automobiles and parts, aerospace and defence as well as consumer goods.<sup>14</sup> In the USA, at Tyco there was looting by the CEO and CFO with improper share deals; at Global Crossing there were inflated corporate profits to defraud

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<sup>7</sup> *Governance of Company Groups* by Mak Yuen Teen & Chris Bennett, The Iclif, Leadership & Governance Centre, CPA, Australia, 2014.

<sup>8</sup> Quotation from Michael Josephson, Founder, CEO and president, Josephson Institute of Ethics, 8117 W. Manchester Ave. #830, Playa del Rey, CA 90293.

<sup>9</sup> Global Leadership Bulletin, *Ethical Principles for Business Executives* by Michael Josephson, 13 January, 2015 accessed at <http://www.standardizations.org/bulletin/?p=133>

<sup>10</sup> Quotation from Edward Hennessy.

<sup>11</sup> The Danger of Runaway Leadership, *Hubristic Individuals are a Threat to Governance*, ICSA Governance & Compliance, May 2017 page 32. Hubris Syndrome is where persons with power become authors of their own doom, with their false sense of invulnerability.

<sup>12</sup> IBE, *Ethical Concerns and Lapses 2017*, Business Ethics Briefing, Issue 59, January 2018, page 5.

<sup>13</sup> The gig economy is defined as the ‘trend of using online platforms to find small jobs, sometimes completed immediately after request or on-demand.’ Instead of being permanently employed, gig economy workers can use online platforms to pick up work on a flexible basis whenever they see fit. Popular gig economy services include professional services, such as cleaning and skilled manual work (TaskRabbit), delivery and courier services (Deliveroo and Just Eat) or driving and ride hailing services (such as Uber), Ibid, page 3.

<sup>14</sup> Ibid, page 1.

investors; and at Xerox there were dishonest accelerated revenue recognition. The collapse of Wall Street demonstrated the importance of ethics, as once highly esteemed financial institutions made headlines for bad choices and questionable behaviour. At Satyam, aka India's Enron, there were malpractices and fraud by the CEO over several years. In Netherlands, at Royal Ahold, earnings were overstated, while at Parmalat in Italy, false transactions were recorded.<sup>15</sup> These demonstrate a total lack of ethics at the very highest level. A properly enforced ethics framework could have averted these failures and scandals.

The governance of businesses includes ethical responsibilities. The principles of business ethics for governance success of subsidiaries and parent companies alike must include: integration, whereby ethics must penetrate all aspects of the business and be reflected in governance systems; promotion of workers, where ethical principles should guide incentive programmes; internationalization, whereby the business must be clear on its definition of ethics and must ensure that it transcends national borders, thereby resulting in an ethics base that is not limited culturally but which can be applied in a global context.<sup>16</sup> Operating without ethics will not only attract huge fines, depending on the offence, but it will also attract significant costs regarding legal fees, remediation work, and lost opportunities. It is certainly less costly to run an ethical business than to engage in unethical practices. Publicly traded 'ethical' companies outperformed the S&P 500 by 9.6% over a four-year period, showing a clear link between ethics and performance.<sup>17</sup> Prevention is always better than reaction and getting it wrong can prove quite costly. After admitting to bribery of government officials in a number of countries, the French transportation company, Alstom agreed to pay some US\$772M. Volkswagen has already incurred fines and customer settlement costs of US\$24.5 billion in the US alone as a result of its emissions cheating. Rolls-Royce has paid some US\$671 million in fines as a result of its admission of bribery.<sup>18</sup>

External elements can prove to be equally toxic as forces within a business if utilized fraudulently. Proof is seen where consulting firms often mask errors instead of accurate and clinical reporting that can serve to stimulate the conscience of a business. Enron was able to secure the 'compromised independence' of public accounting firms, which not only bankrupted the company, but destroyed Arthur Andersen, one of the largest audit firms in the world. At Satyam, the fraudulent activities of the CEO took place over several years, despite having PwC as auditors. The government had to intervene and appoint new auditors: KPMG and Deloitte. The report into Lehman Brothers showed that the Lehman's auditors knew of the accounting irregularities and failed to raise the issue with the Lehman's board. The name of a large audit

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<sup>15</sup> Alexandru Panfilii, Iulia Popa, *Failure of Corporate Governance – Intention or Negligence*, West University, Faculty of Economy and Business Administration, Timisoara, Romania.

<sup>16</sup> Adapted from the International Business Ethics Institute and the Caux Roundtable on Moral Capitalism at Work.

<sup>17</sup> *The Best Line of Defence*, An Effective anti-corruption and bribery programme is vital to protect a company's reputation, ICSA, The Governance Institute, Governance and Compliance, June/July, 2017.

<sup>18</sup> *A Worrying Disconnect*, Failure to follow through on reported ethical values with actual behaviour is destructive, ICSA, The Governance Institute, Governance and Compliance, May, 2017, page 27.

firm – Ernst & Young – yet again appeared having been paid over \$185 million by Lehman Brothers in its last year of financial reporting. These independent auditors displayed a dismal application of ethics in the performance of their duties. While it may be easy to blame the ‘system’, the system is comprised of decision making persons, who must own up to the responsibility to make ethical decisions because it is the right thing to do.

While obeying the laws and having codes of ethics can be seen as hallmarks of a well-run business, these are simply not enough. Few businesses can attest to Thomas Jefferson’s statement that, ‘in matters of principle, stand like a rock.’ Publicly traded businesses have a legally mandated fiduciary duty to their shareholders to maximize the profit of the business. There is no equivalent legally mandated ethical duty. BP’s decision to circumvent safety protocols resulting in a massive oil spill in the Gulf of Mexico shows that BP’s fiduciary duty trumped its ethical obligations to protect the environment.<sup>19</sup> While laws do not guarantee the elimination of unethical practices, they do provide a way to legally address such behavior. The FSGO<sup>20</sup> provides additional incentive for having codes of ethics and ethics training.<sup>21</sup> While SOX, C-SOX and J-SOX<sup>22</sup> specifically state that destroying evidence or fraudulent behaviour is illegal, they do not cover the series of questionable decisions that lead to the fraud as well. At Volkswagen, the execution of the deceptive computer program at the EPA emissions test laboratory is where the law was broken, the commission of which carries punitive fines and penalties. However, the plan that preceded that breach and the culture of deception that brought it to fruition, constitute a string of ethical violations that must also be addressed.

A written ethics policy and a code are not enough, as the words are just the beginning. Many businesses do nothing more than paste these on their walls to impress others. The senior managers who drafted the statements then lose credibility by proclaiming values and not living up to them.<sup>23</sup> According to the IBE’s statistics, 95% of the miscreants have codes and values defined. Grant Thornton’s annual review ‘The Future of Governance’ shows that while 86% of FTSE 350 companies mention corporate culture in their annual reports, 48% do not clearly communicate their organization’s values.<sup>24</sup> Despite having a CSR task force and a code of conduct, no one in Enron followed the code and violations were prevalent.<sup>25</sup> At Volkswagen, its’

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<sup>19</sup> *The Ethical Lessons of Deepwater* by Marion Hart, ASME, accessed at <https://www.asme.org/engineering-topics/articles/engineering-ethics/the-ethical-lessons-of-deepwater>, on 9 March, 2018.

<sup>20</sup> The Federal Sentencing Guidelines for Organizations: A Framework for Ethical Compliance by O.C. Ferrell, Debbie LeClair, and Linda Ferrell, accessed at <https://danielsethics.mgt.unm.edu/pdf/FSGO%20-%20A%20Framework.pdf> on 9 March, 2018.

<sup>21</sup> BOMI International, Independent Institute for Property and Facility Management Education, *The Business of Ethical Behaviour* at [http://www.bomi.org/uploadedFiles/2010\\_New\\_Site/Homepage/News/BOMI%20Press%20Release\\_BGE%20Smart%20Energy%20Savings\\_09-03-2015.pdf](http://www.bomi.org/uploadedFiles/2010_New_Site/Homepage/News/BOMI%20Press%20Release_BGE%20Smart%20Energy%20Savings_09-03-2015.pdf).

<sup>22</sup> *Comparing U.S. Sarbanes-Oxley with C-SOX (Bill 198) and J-SOX (FIE)* by Protiviti, Knowledge Leader on Mon, Sep 11, 2017 accessed at <http://info.knowledgeleader.com/comparing-sox-with-cxos-and-jsox> on 9 March, 2018.

<sup>23</sup> Supra, note 7.

<sup>24</sup> Supra, note 18.

<sup>25</sup> For example, when the company allowed the CFO to serve on the SPEs; when the audit committee allowed suspect accounting practices and made no attempt to examine the SPE transactions; and when the auditors failed to prevent questionable accounting.

low emissions diesel engine was touted as a win for the environment and the business benefitted in both reputation and profit. However, that reputation belied the truth, because the ethical culture of Volkswagen, was at opposition to the CSR that it touted. Despite 90% of all *Fortune* 500 companies having codes of conduct, 70% having statements of vision and values,<sup>26</sup> these companies may be better off ‘codeless’ because these codes remain in the doldrums.

Ethical behaviour by a business is even more important than its economic performance or the quality of its products because ethics can be its best calling card<sup>27</sup>. Data from the Ethisphere Institute shows that financial metrics and ethics are inexorably tied together. This is dubbed the ‘ethics premium’ and has been borne out through long-term tracking by the Ethisphere Institute of how the stock prices of publicly traded honorees compare to the U.S. Large Cap Index. Listed World’s Most Ethical Companies outperformed the large cap sector over five years by 10.72 percent and over three years by 4.88 percent.<sup>28</sup> Successful companies like Dell Technologies, Volvo Cars, Microsoft, Aflac, Voya and L’Oreal<sup>29</sup> recognize and value ethics as not mere ‘afterthoughts’ in the business world, but for the ‘table-stakes’ for which they are. ‘Being good is indeed good business.’<sup>30</sup> While businesses seek to derive profits, the people that control businesses cannot escape the ethical element, where decisions require that ethical implications be weighed before acting. UPS Company uses ethics as a core business strategy with a worldwide ethics plan, where the code of conduct is available in 12 foreign languages, and mandates that workers know and apply ethical practices. Coca Cola ensures honesty and integrity in all matters by policing its code of business conduct and Microsoft has placed ethics at the forefront of its governance model.

A well-defined and relevant ethical framework for the people that comprise the business is essential. This will address the root cause of governance failures and not just what is aesthetically appealing. A framework, sanctioned by the board, embedded at the core and serving as the pulse of all business operations, must cascade throughout the business, inculcating and entrenching ethical business behaviour. Leveraging technology to manage subsidiary networks and bring order to subsidiary governance<sup>31</sup> is reliant on people for performance. Focus on risk appetite and capital, risk management, escalation in group structures, information systems, or the corporate secretarial function,<sup>32</sup> will all collapse, unless the people responsible for executing these functions are equipped to make ethically sound decisions. Laudable initiatives, such as creating a Subsidiary Governance Office (SGO), appointing a Subsidiary Governance Officer, staffing the SGO with competent persons, having a Subsidiary Governance and Oversight

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<sup>26</sup> Supra, Note 18.

<sup>27</sup> According to Kathy Ireland.

<sup>28</sup> Supra, note 1.

<sup>29</sup> L’Oreal has been named as a 2017 World’s Most Ethical Company by the Ethisphere Institute for the 8<sup>th</sup> time.

<sup>30</sup> Quotation from Dame Anita Roddick.

<sup>31</sup> *Five Entity Management Best Practices for Your Company* by Nicholas J. Price, November 6, 2017 accessed at <https://diligent.com/blog/five-entity-management-best-practices> on 12 March, 2018.

<sup>32</sup> ICSA, Governance & Compliance, *Local Difficulty, Proper Governance of Subsidiaries can Overcome Jurisdictional Problems*, by Jonathan Hayward, April, 2017.

Committee<sup>33</sup> – will all amount to zero, unless the people responsible for execution operate ethically.

The board and executives must exemplify the code and must themselves be credible, committed, and consistent regarding enforcement. The most compelling support for an ethical framework is adherence to and enforcement of that standard of behaviour by those who institute it. Johnson & Johnson has become well known for its Credo Challenge sessions, in which managers discuss ethics in the context of their current business problems and are invited to criticize the company's credo and make suggestions for changes.<sup>34</sup> Executives must own up to their critical role in setting the ethical tone. Employees tend to follow leaders' cues, which makes it especially problematic when leaders break rules or violate standards of integrity.<sup>35</sup> Implementation of the ethical framework demands a multi-faceted approach. A Senior Head of Ethics, who is objective and reputable so that employees know there is no favoritism and bias, must form a permanent part of each business structure. Whether known as Chief Ethics Officer (L'Oreal), Global Ethics & Compliance Director (Dell) or Chief Compliance & Ethics Officer (Volvo Car Corporation) - this high level position is key to implementation.

Businesses must not just warm up, but must heat up to the idea of operating ethically by facilitating well constituted Ethics Committees throughout business operations which can be utilized to embed the ethical framework. In discussing the collapse of public relations firm Bell Pottinger, it was noted that these committees can be very useful in instilling the business values of an organization.<sup>36</sup> Businesses must take action by appointing Ethics Emissaries or Champions who are passionate about serving in this role, and who will reach every nook and cranny of business operations. A well-considered Ethics Communications Plan for the entire business must operate in tandem with these committees and other initiatives for the successful implementation.

In policing the ethical framework, innumerable options are available. Ethics Panels, consisting of reputable executives, should be established to investigate and adjudicate whenever it is not clear whether ethical boundaries have been crossed. Ethical decision-making and displays of ethical behaviour must be incorporated into the performance appraisal and rewards system. This system ought to promote ethical behaviour, where whistleblowers who notify management of problems are not only guaranteed privacy, but such behaviour should be rewarded. Versions of EthicsLine<sup>37</sup> can certainly keep businesses informed via interaction with

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<sup>33</sup> Association of Corporate Counsel, *Corporate Subsidiary Governance: Leading Edge Practices*, Insights from David Allgood, Chief Legal Officer, Royal Bank of Canada.

<sup>34</sup> Harvard Business Review, *Values in Tension: Ethics Away from Home* by Thomas Donaldson, September–October 1996 Issue accessed at <https://hbr.org/1996/09/values-in-tension-ethics-away-from-home> on 12 March, 2018.

<sup>35</sup> According to global Ipsos MORI research in April 2013 accessed at <https://www.ipsos.com/ipsos-mori/en-uk> on 12 March, 2018.

<sup>36</sup> ICSA, Governance & Compliance, Ethics, *It Tolls for Thee* by Jimmy Nicholls, October 2017, page 8.

<sup>37</sup> The Coca Cola Company, *Governance & Ethics*, September 20, 2016, EthicsLine, is a global Web and telephone information and reporting service, where telephone calls are toll-free and available 24 hours a day, 7 days a week, with translators available. Accessed at [coca-colacompany.com](http://coca-colacompany.com) on 12 March, 2018.

and feedback from stakeholders. EthicsChat sessions that mirror the Credo sessions of Coca Cola will provide the opportunity to have questions on ethics answered and uncertainties clarified. This will allow businesses to continue evolving ethically and reinforcing an ethical ethos where persons are accountable for ethical breaches, regardless of rank or status and where, there are consequences for unethical behaviour. Businesses must spice up the 'ethics rollout' by having clear sanctions for dissenters but yet demonstrate flexibility for local nuances.

It is neither a matter of economics nor a matter of law. Governance success is really an all-out matter of ethics. When the law is silent, ethics speak volumes to fill the lacuna which would otherwise lead to governance failures. Businesses need to stop underestimating the importance of ethics and instead move swiftly to include ethics amongst the other areas that they may hold in high esteem, namely bankers, auditors and tax consultants. Now is the time for C-Suite executives to be nimble and recognize the signs that undisputedly point to embracing ethics as the main ingredient for averting governance failures. Businesses that passionately and effectively 'police' their ethics frameworks, with concerted and consistent action over time, can surely be prepared for governance success!

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