

# The Study of Relationship among Ethical Leadership and Organizational Performance in Corporate Governance in the Public and Private Sectors of Islamabad/Rawalpindi, Pakistan

Wajiha Khalid

Army Public College of Management and Sciences (APCOMS), UET taxila

## Abstract

Gradually and progressively corporate governance is diverting world's attention towards itself, not solely because nowadays we live are living in societies that need to be governed properly but more by virtue of this world been converted into a global village, so this research is conducted to find out the relationship of ethical leadership with corporate governance practices. The instrument used for collecting the required information was questionnaire developed by Wu (2006). Descriptive statistics, regression and correlation were used for the purpose of data analysis. Results obtained showed positive relationship between ethical leadership, corporate governance practices and organizational performance.

**Keywords:** Corporate governance practices, ethical leadership, organizational performance.

## 1. Introduction

Corporate governance is an observable fact that has been contemplated globally. In emerging economies like Pakistan, the guidelines and strategy formulators are giving noticeable consideration to corporate governance practices. To implement corporate governance practices in the country, the government of Pakistan in 1997 established Securities and Exchange Commission of Pakistan. It was a regulatory body that has to insure economic growth by efficient supervision of corporate sector and capital markets. This body was based on world's best practices and international legal laws, and it kept on improving itself with time (Rais and Saeed, 2004).

Corporate governance is the way to govern, direct and manage the corporation. It means run the business according to the desires of the stakeholder's, led by board of directors (BODs) and the concerned committees for the benefit of organization's stakeholders. It is basically the relationship between shareholders, BODs and company's management to decide which direction organization will choose. There should be no conflict between principal and the agent and they have to build healthy relationship (international finance corporation).

Ethics is regarded as rules of conduct that guide individuals in making right or wrong decisions. Those having empowerment in an organization makes decision individually or by taking feedback from teams, but that verdict is determinant of the organizational culture as well. Ethical organization as an institute where organization leader's act as role model for the entire organization, their behavior is in accordance with ethical norms and values and unethical ways are dejected (Francis and Armstrong, 2003).

Every employee has the choice to act in an ethical or unethical manner. Despite of this choice available, they should decide what is right for them, for the organization and ethically also. They should adopt fair and honest practices in each and every dealing being made and avoid such customs that lead to immediate and temporary earnings. Corporate governance innovative procedures states transparency and disclosure in every business step been taken and eradication of fraud and corruption from every level within the organization. Corporate governance sets minimum benchmark that is to be followed by doing business and implemented by those who operate the business (Dandino, 2004).

Ethics in corporate governance refers to company's policies and processes that deal with those issues which are related to the day to day operation of the business. The basic purpose of the business is to generate profit but that purpose must be achieved in an ethical way. There must be a balanced approach between profit generation and ethical issues. Conflict in corporate governance practices arises when more attention is given to the needs and interests of majority shareholders so that minority shareholders can get their rights as well. This convention gives more delegation of power to managers and chances of ruinous activities increases (Becht et al, 2003). Such ways are to be devised that put an end to such customs. The main objective of good corporate governance is not only to provide top management and board of directors with huge remuneration but also to do hard and sincere work in order to follow the practices and procedures that leads the company to success and ensures the wealth maximization of its shareholders (Maier 2005). The corporate governance has a significant impact on internal capital markets. Specially, ownership attention reduces the scope of corporate diversification, but increases the probability that internal capital markets are well-organized (Sautner and Villalonga, 2010). We have been included in the list of lower developing countries. The concept of corporate governance is getting momentum day by day in Pakistan. Keeping in mind the importance of corporate governance and its ethical perspective, Pakistan has passed the first stage of drafting the governance practices to be followed by the country's corporate

sector, done by its security and exchange commission (SECP). State bank of Pakistan made many important rules and regulations to improve the corporate governance.

In Pakistan every single company that has registered itself with Karachi Stock Exchange (KSE) and Security and exchange commission (SECP) are bound to follow the prescribed regulations and guidelines. Companies including insurance and asset management firms, who fail to register themselves, are still obliged to follow these rules in all their business practices. According to the approved code of conduct, the board of directors duties include developing strategic plans, proper resource allocation and utility, management of routine business operations, having close supervision and monitoring, equality and justice with all, disclosure of material information, ethical traditions and protecting the right of every stakeholder (revised code of corporate governance, 2012).

Basic aim of this study is to find out the impact of ethical leadership on performance of public and private firms located in vicinity of Rawalpindi/Islamabad. Ethical leadership is vital for organizations sustainability and long life and is mandatory for implementing and practicing corporate governance. By gathering responses of employees, we will analyze how this relationship works in businesses.

## 2. Literature Review

Wieland (2001) defines ethics in governance as the integration and amalgamation of morals and norms that are necessary for running the management. These are guidelines mandatory for operating and controlling a firm. To incorporate ethical governance in the roots of any organization, the corner stone is to slot it in the behavior of organization directors, as their practices are to be followed by the entire company. Any organization failing to do so or showing variation in their ethical conduct will loosen its good name and credibility (Driscoll, 2001). Starting corporate ethical programs in any organization helps in reducing the number of conflicts which may arise and it also ensures the smooth going of operations. It's the responsibility of directors to forecast the future scenario and make rules accordingly (Felo, 2001). In today's business environment, businesses are facing many ethical issues, some of these include tax saving, corruption, fraudulent activities, and not providing proper rights to shareholders (Tam, 2002).

Wu (2002) regards businesses as humans being, they are flexible. There are no hard and fast rules which are to be followed each and every time. But to be successful and to avoid failure, certain set of laws are to be obeyed. Owner of the business is to be very careful about changing the governance policies, as in some cases it adverse the situation instead of improving it. Shareholder wealth can be increased through building better relations with primary stakeholders like suppliers, customers, employees and communities who can help the firm to create those intangible, valuable assets which can get competitive advantage for the firm. Those resources which are not related to those primary stakeholders may not create shareholder wealth (Hillman and Keim, 2001).

To make business successful and prosperous, there is need to grow such leaders who have strong moral character, experience and able to provide the business with required and desired results (Kaufmann and Olaru, 2012). According to (McGuire et al, 2003) organizational leaders are supposed to be emotionally and morally strong. They should bring creativity and innovation in conventional business practices that would help the firm to sustain itself in long run and will also add to its value creation. They integrated their knowledge and come up with best possible solutions for the business.

Francis and Armstrong (2003) define ethical organization as an institute where organization leader's act as role model for the entire organization, their behavior is in accordance with ethical norms and values and unethical ways are dejected. Directors are well aware about the importance of their decisions and its effect on the entire working of organization. Existing corporate laws force directors to focus on maximizing shareholders wealth only and not paying proper attention to corporate governance (Rose, 2007). It is then necessary that stakeholders are to be motivated to pay attention to corporate governance issues. These issues are too enlightened and stakeholders should take an account of them.

To influence people in your organization, it is mandatory to have proper norms and values prevailing in the organization. Such policies and procedures are to develop that increases the social outcome of employees and incorporate sense of responsibility in them (Graaf and Herkströter, 2007). Corporate governance has two different approaches, first one talk solely about the rights of owners and second one talk solely about the rights of employees. Such practices are to be adopted those facilities both the parties, giving more importance to making the most for shareholders (Bird et al, 2007).

The breakdown of the current situation of compliance with corporate practices is solely not the collapse of authorized obedience but basically the failure of doing the work in desired way (Arjoon, 2005). The main idea behind giving the detailed information about ethical issues to understand the moral subjects which are helpful to conduct ethical leadership and honesty between individuals and organization and meet the requirements of CSR (Park, 1998). Ethics is about belief, norms, values and trust. In corporate ethics companies have to take care of their customers and share holders along with faithfulness with country. Economic structures and culture have an impact in finding the stability between shareholders and stakeholders in different regions. Reddy (2009) noticed

the apparent tilt toward the stakeholders' point of view in large sections of the Asian economy, mainly on relation of block-shareholding with control over managements; supremacy of State ownership; and the objective of the newly internationalizing companies to meet the competitive demands of input and output markets relating to stakeholders. He argues that the cultural influence such as relation-based precedence and social expectations of "duties" entail a different approach from the Anglo-Saxon contractual construct.

There is dualism of the culturally determined practices co-existing well with the international standards. Rossouw (2009) developed a framework for comparing different corporate governance regimes round the world. In his study he makes a comparison among four regional perspective of corporate governance including Asia, Africa, Europe and North America. Having a sustainable and implementable corporate governance system means that every participant is well aware of their duties and responsibilities. This system also states that corporation is ethically and morally responsible to its society as well. Throughout the world different corporate practices are been adopted and implemented. There is a need to make comparison among them and then implement the best practices available.

Corporate governance related rules regulations and direction are based upon the opinion of a corporation's role, responsibilities and compulsion in a particular society. Maintaining the rules of corporate Governance is responsibility of board. Board of directors is responsible for transparency in practices. Especially outside directors consider more effective in embracing CSR and ethical balance. Outside or independent board of directors is believed to be independent of management so are much likely to stand against Chief Executive Officer (CEO) for protecting the interest of shareholders. This is why they are top preference of corporate governance reform.

The new set of laws that comprises of the Sarbanes-Oxley Act of 2002 (SOX) and the regulations disseminated by the National Association of Securities Dealers (NASD), Securities and Exchange Commission (SEC), and New York Stock Exchange (NYSE), integrate the idea that outside directors are significant guardians of shareholder interests and to bring ethics by requiring greater participation of outside directors on the board and key committees. Ever since extended clash of views exist on the board of director's structure or composition and its role in governance and performance of the business.

Two schools of thoughts present their conflicting concepts. One says that outside directors are not as efficient in managing the agency issues and effective monitoring compared to their counterpart inside directors. This is because of their lack of information regarding inside matters and corporate culture (Berle and Means, 1932; Fama and Jensen, 1983). Addition of such outside directors prove beneficial only when the expenditure of obtaining information regarding firm is small and if cost is high outside directors have no effectiveness (Duchin et al. 2010; Mauge, 1997). Also argues that there is no positive or negative change in average term in profitability and performance of company only information cost matters.

Hossain et al (2001) found out that there lies a significant relationship among the performance of a corporation and its autonomous and self governing board of directors. Independent Board of directors is tool for efficient and useful implementation of policies and good governance. A view that board structure should also include employee representation (Demirbas and Yukhanaev, 2011). Stander and Poor (2004) use board and management structure for ranking of corporate governance among other Indices including financial transparency, ownership structure and investor relationship etc. Dominguez et.al (2009) finds out a positive relation in corporate ethics, governance and presence of female board members. He argues that because of board ownership a clash between investors and management exist which can be avoid and better addressed with presence of independent outside directors.

Good governance can be achieved through effective implementation of policies and this effectiveness relies on good institutions and authorities (Roy and Tisdell, 1998). Despite indisputable efforts of the individual who are accountable for developing the CSR policy for tackling stakeholder's apprehensions, certain rules and regulations within the CSR policies hampers it from providing the material and necessary information to its stakeholders. These are certain limitations and constraints of the policies which have been implemented (Whitehouse, L, 2006). Directors of broader view and wider social and economic goals steady with CSR are more efficient in maximizing shareholder's wealth (Tudway and Pascal, 2006).

The major objective of the study included verifying aspects like global society that have a major influence on the businesses to adopt corporate governance practices, and by removing the hindrances to ethically ideal behavior (Wu, 2006). The principles based and rules based approaches are captured by the risk based approaches, by incorporating trust based principles like covenantal, subsidiary and solidarity relationships (Arjoon, 2006).

Organizational leaders are supposed to depict strong moral and ethical character and act as role model for the entire corporation. They are believed to be charismatic leaders but this is not easy in today's business world as each person lives inside the box, not taking any risks, not doing anything exciting, and not taking any chance. Business leaders are to full fill the expectations people have associated with them, they are not supposed to act like political leaders who motivate people at the time of elections by giving them false hopes and then afterwards they fail to act upon it. There are also such stories associated with business leaders, as we have good and bad

people in every field of life. Chief executive officers are considered ethically and morally strong in today's business society (Jenkins, 2006).

In a global, unregulated and an open economy, the time of academics along with possession of public and companies administration has been occupied by problem of corporate government. The variations in the corporate governance are due to the several factors including the economic situation, organizational structures and the culture of that particular country. Therefore, there is no single solution which can be universally applied and is valid in all the situations. So, for effective and efficient corporate governance guidance, to propose some specific principles which can stand the appropriate test of experience are still possible (Fernández, 1999). It is also argued from the corporate communication perspective that in creating a competitive advantage corporate social reporting can also be used: people can be prepared to do a business with the organization and also to buy their products; it can be implied by creating a positive image (Hooghiemstra, 2000).

In order to manage organizational ethics huge efforts that are morally obligatory are put forward by multinationals. But firms that quickly adapt American style ethics faces risk failures in accomplishing their purpose (Weaver, 2001). The need of external stake holders should be met by managers of internal stake holders, their coordination and effectively managing the corporate image results in growth and survival of manufacturing firms (Sirgy, 2002). Critical reflexivity, openness, responsiveness and social connectedness are the factors that identify corporations as being ethical (Balmer et al, 2007). Stakeholders including creditors, managers, investors, governments and suppliers, cut across religious, political, cultural, national and philosophical barriers in domestic and multinational corporate activities. Meanwhile the difficulty to establish certain common norms for employee and managers tolerated by the potential issues like bribery, gift taking, nepotism, child labor, sexual harassment and discrimination highlights the challenges faced by the companies that try to develop a code of ethics (Schwartz, 2005).

Along with failures of legal compliance fundamental failure to do the right thing contributes to the failures of corporate responsibility (Arjoon, 2005). Workers give their best input and work with motivation when they have assurance of having a conscious and principal employer. If employers do not possess the quality of responsiveness and justice then as a result they would not be able to keep their high quality staff. Employee retention rate and attracting new fine talent will decrease simultaneously. As a result of all these events, business expenses will increase and overall efficiency and effectiveness will reduce. Despite of all these facts, corporations cannot work properly lacking human power as they are its intellectual capital (Morimoto et al, 2005).

Internal capital markets are significantly affected by corporate governance. The scope of corporate diversification has been reduced by the ownership attention but resulting in the increase of the probability of well organization of internal capital markets (Sautner and Villalonga, 2010).

### **3. Methodology**

#### **3.1. Population**

To make this study generalize and make full use of the results obtained, public and private sector of Rawalpindi and Islamabad/Pakistan were taken as population of the study. For the purpose of data collection, companies were chosen on the basis of number of customers, company size and performance. Private companies which were chosen include Mobilink, Askari Bank and Fauji Fertilizers. Public companies include National Bank, Sui Northern Gas Pipelines Limited and Pakistan International Airlines. Employees working at managerial positions in these organizations are in a better place to judge whether these organizations practice ethical leadership or not. Employees having large number of years as experience give more accurate feedback as they know well about the organization. In the study conducted, unit of analysis is individuals, as data for study is collected from employees working in the selected firms.

#### **3.2. Procedure**

For equivalent representation of both public and private sector, equal number of responses was collected from employees of all six selected companies. Elements of study were chosen by using disproportionate stratified random sampling technique. Questionnaires were distributed in these organizations and collected back after a period of ten days. Questionnaires were filled by having minimal interference with the respondents. This is a correlation study conducted in non-contrived settings. Results depend on 180 responses collected and analyzed using SPSS.

#### **3.3. Measures**

Respondent's demographic data was gathered on the footing of seven measures which include age, gender, job, income level, years with organization, nature of organization and highest level of education. To gauge ethical leadership, corporate governance practices and organizational performance, sixteen question items were used in total. Ethical leadership was assessed with four items developed by Wu (2006) and responses measured on likert scale ranging "1" very disagreeable to "5" very agreeable. The practices of corporate governance were assessed with eight items developed by Wu (2006) and feedback calculated on likert scale ranging "1" nothing to "5"

everything. Organizational performance was assessed with four items developed by Wu (2006) and answers computed on likert scale ranging “1” very dissatisfied to “5” very satisfied. We know that to measure internal consistency cronbach’s Alpha is used. The value of cronbach’s Alpha for all the three variables is more than .70 which shows that the instruments which we are testing are reliable.

**Table 1:** Results showing reliability statistics

Reliability Statistics		
Constructs	Cronbach’s Alpha	N of Items
Ethical Leadership	0.89	4
Corporate Governance Practices	0.81	8
Organizational Performance	0.84	4
Overall	0.85	16

#### 4. Research Model



#### 5. Hypothesis

By keeping in mind the variables of this study, subsequent relationships are created.

**H1:** The ethical leadership of corporations can directly influence the corporate governance practices.

**H2:** Corporate governance practices can directly influence organizational performance.

**H3:** Ethical leadership and corporate governance practices increases organizational performance.

#### 6. Data Analysis

Data gathered from public and private firms, was analyzed with the help of tests. Items used to measure the variables of interest in this research project, are analyzed thoroughly. Data collected was analyzed by using descriptive statistics, correlation and regression. Results obtained after SPSS analysis are interpreted and used to reach the conclusion.

##### 6.1. Demographic Distinctiveness of Respondents

Correspondents were judged on the basis of age, gender, highest level of education, job, income level, nature of organization and years with organization. Questionnaire used to collect data from respondents has demographic section on top. Results showed that employees having income level above 50,000 more strongly belief that ethical leadership in organizations leads to its good performance. Demographic statistics are present in the form of table and are explained below.

##### 6.2. Demographic Statistics

Demographic statistics of respondents were collected that helped in grouping them and in results generalization. Results obtained from frequency and percentage analysis showed that most of the employees working in public and private sector fall in the age group of 26 to 30 years. 112 of the total respondents were male and 68 were women. Education level of respondents varied greatly. Highest percentage of correspondents (49%) was having master degree and minimum was PhDs (8%). Mainly managerial level employees were questioned about the ethical leadership being practiced by top management and they represent 69% of the total sample. Largely the employees have income level below 50,000. Employees have large number of years as experience were targeted in sample, as they are in a better position to tell about the corporate practices implemented in the firm and they represent 38% of the respondents. Equal representation of both public and private sector was taken for study i.e. 50%.

**Table 2:** Results showing demographic analysis

Measures	Items	Frequency	Percentage
<b>Age</b>	20 or below	8	4 %
	21-25	35	19 %
	26-30	52	29 %
	31-35	36	20 %
	36-40	30	17 %
	41 or above	19	11 %
<b>Gender</b>	Male	112	62 %
	Female	68	48 %
<b>Highest Level of Education</b>	Bachelors	45	25 %
	Masters	87	49 %
	MS/M.Phil	34	18 %
	PhD	14	8 %
<b>Job</b>	Managerial	124	69 %
	Non Managerial	56	31 %
<b>Income Level</b>	Below 10,000	6	3 %
	11,000-20,000	15	8 %
	21,000-30,000	31	17 %
	31,000-40,000	39	23 %
	41,000-50,000	58	32 %
	Above 50,000	31	17 %
<b>Years with Organization</b>	Less than a year	37	20 %
	1-5 years	48	28 %
	6-10 years	69	38 %
	10 or above years	26	14 %
<b>Nature of organization</b>	Public	80	50 %
	Private	80	50 %

### 6.3. Descriptive Statistics

Descriptive statistics were applied on the results gathered and mean, mode, median and standard deviation were calculated. Question items were assessed on a five point based likert scale ranging from “not agreeable” to “very agreeable”, “very dissatisfied” to “very satisfied” and “nothing” to “everything”. Mean value calculated for all the three variables are greater than 3.00, showing the representativeness of data. Values for all variables shows positive trend. For ethical leadership mean value are 4.42, which states that employees were agreed by the question items related to ethical leadership. Standard deviation values calculated are also less, which affirms that the observations lie near mean values.

**Table 3:** Results showing Descriptive Statistics

Constructs	Mean	Standard Deviation
<b>Ethical leadership</b>	4.4231	0.52190
<b>Corporate governance practices</b>	4.6590	0.47245
<b>Organizational Performance</b>	4.4561	0.56193

Correlation analysis is used in this study to measure the association between variables and strength of relationship. Correlation values for all variables are positive, conditioning a positive relationship among them and their positive co-relatedness. Highest value of correlation i.e. 0.44 is seen between corporate governance practices and organizational performance, stating firsts direct influence on the second one. Correlation value of between ethical leadership and organizational performance is 0.41, stating the positive impact of fair and just leadership on efficacy of organizations. Lowest but still statistically significant correlation value is sighted between ethical leadership and corporate governance practices been adopted by organizations in their business functions.

Results obtained from correlation analysis proved the hypothesis H1, H2 and H3 and supports that their lies a positive relationship between “ethical leadership” “corporate governance practices” and “organizational performance”.

**Table 4:** Results of correlation analysis

	Ethical leadership	Corporate governance practices	Organizational Performance
Ethical leadership	0.91		
Corporate governance practices	.391(**)	0.82	
Organizational Performance	.414(**)	.437(**)	1

\*\* Correlation is significant at the 0.01 level (2-tailed).

Regression analysis is implemented in this study to forecast the reliance of one variable on another variable. Results obtained shows that that impact of ethical leaderships being followed in public and private firms is 25 % on their corporate governance, which means corporate governance is observed in organization as a result of their moral leadership practices. There is 43 % probability that corporate governance practices in organizations leads to their favorable performance. Coefficient of determination values for ethical leadership and corporate governance practices are 0.37 and 0.30, showing their individual contribution in organizational performance. T values for independent variables were greater than 2 showing considerable relatedness. P value is zero, showing maximum significance of the relationship under study.

**Table 5:** Results showing regression analysis

<b>Model Summary-I</b>					
Dependent Variable	Independent Variable	Adjusted R Square	$\beta$	<i>t Stat</i>	<i>P-value</i>
Corporate Governance Practices	Ethical Leadership	0.258	0.375	5.734	0.0000
<b>Model Summary-II</b>					
Dependent Variable	Independent Variable	Adjusted R Square	$\beta$	<i>t Stat</i>	<i>P-value</i>
Organizational Performance	Corporate Governance Practices	0.473	0.307	6.922	0.0000

## 7. Discussion and Findings

Results obtained after careful analysis of data shows that organizational performance depend 26 % on the variables selected in this study and remaining 74 % on other variables. 16 question items were used to gauge ethical leadership, corporate governance practices and organizational performance. Results obtained in this study are in coherence with the previous researches done in this area.

Both regression and correlation analysis results showed positive values, which affirms strong and direct relationship among all the variables of the study. Leadership in public and private firms monitors the working of entire business by making supervision effective. Leadership has a vital role to play in enhancing the morale and motivation level of managers and getting maximum output from them. The responsibility of looking safeguarding the rights of investors, stakeholders and society, all lies on the shoulder of firm's leadership. Ethical leadership is not just mandatory for efficient business processes, but it is also required for building firms' reputation in the market. Results illustrate that ethical leadership along with influencing the insurance of corporate governance and high organizational performance also helps to obtain trust of the society and public at large.

Results demonstrate that ethical leadership being practiced in public and private firms is positively correlated with corporate governance. Corporate governance is the product of morally strong leadership. Strong leadership provides shareholders with many rights, such as questioning, making proposals, giving recommendations to the board of directors. All this is possible only when leadership is strong and motivated and as a result high organizational performance is achieved. Issues including inside trading and informational justice can be eradicated by having well organized and well supervised monitoring system. Leadership assures the compliance of every employee and every business process with the code of conduct procedures. Shareholders and stakeholders are to be informed about the potential risks and hazards, well in time. Management ensures transparency of every process, proper disclosure of information and formation of short-term and long-term strategies.

Highest correlation value is sighted between corporate governance practices and organizational performance, describing the vital role played by good corporate governance in organizational success. When ethical leadership is there and corporate governance is practiced in a firm, it helps in reducing the overall cost of operations, inducing efficiency and building organization image among the general public. For ongoing business concern and for the sake of attracting more investment, ethical leadership and corporate governance is an obligation.

## 8. Conclusion and limitations

This study helped in studying the impact of ethical leadership and corporate governance on organizational performance in public and private sector. Results gathered from respondents showed that ethical leadership in organizations pave the way for corporate governance and corporate governance leads to better and higher organizational performance. This relationship was created in research model and the results obtained from regression and correlation analyses seconded it. Supervision and monitoring from management plays great role in business success and corporate governance practices are more fruitful in such conditions.

In Pakistani business environment, ethical leadership influences organizational performance by going through corporate governance mediator. The positive relationship among the variables of study in the proposed model and then in the generated results shows that if ethical leadership in organizations is augmented, more is the corporate governance practices their and as a result boosted organizational performance. Results are vice versa in the opposite case.

Limitations of this study were small sample size. Sampling was limited to six public and private companies. Other organizations are their which could have been selected for research purpose but due to time and resources constraints, sample size was limited.

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