CORPORATE GOVERNANCE AND ITS EFFECT ON ETHICAL LAPSES

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Abstract

How to cite this paper: Gavin, D., & Gavin, J. (2023). Corporate governance and its effect on ethical lapses. Corporate Governance and Sustainability Review, 7(4), 8–17. https://doi.org/10.22495/cgsrv7i4p1

There is much research that examines the connection between different elements of corporate governance to specific firm outcomes (Brahmana et al., 2021; Fakhfakh & Jarboui, 2022), including ethical outcomes (Veldman et al., 2023). However, little is written about how to prevent ethical lapses from ever happening. Using the framework of agency theory, this study examined the effect of the board of directors' power and the chief executive officer's (CEO's) power on the firm's ethical behaviors. We sought to find out if strong governance, whether CEO or Board, could play a role in stopping ethical lapses before they happen. To evaluate this relationship, two indices were used. The board power index included board size, non-duality, lead director, board composition, and ownership. The CEO power index included tenure, ownership, and board member nominations. The sample consisted of 102 large, public United States (U.S.) firms. Logistic regression was utilized to determine if board power or CEO power could influence ethical firm behaviors. The findings indicated that strong boards were associated with more ethical firms. CEO power did not seem to have the same relationship. These findings are important to help firms structure boards to increase vigilance and reduce the likelihood of ethical lapses.

Keywords: Corporate Social Performance, Corporate Governance, Ethics, Social and Governance Factors

1. INTRODUCTION

Agency theory is about power (Finkelstein et al., 2008). In the corporate boardroom, the power is related to the two main parties: the board of directors and the chief executive officer, CEO (Gilley et al., 2023; Combs et al., 2007; Davis et al., 1997). The board’s vigilance over the firm’s activities is directly related to the level of board power (Finkelstein et al., 2008). CEOs need power to run the organization and to survive the ups and downs of the marketplace. Without power, CEOs would have difficulty making and executing difficult decisions. Without some level of power, using authority would be next to impossible.

Boards of directors exist to protect the shareholders’ interests. In general, the board’s responsibilities include selecting and disciplining the CEO, approving executive compensation, approving the firm’s strategy, and overseeing the firm’s operations (Finkelstein et al., 2008). To accomplish these responsibilities, the board needs power.

Under the framework of agency theory, recent research has examined the effect of CEO power on the relationship between retrenchment strategy and firm performance (Brahmana et al., 2021), CEO duality and firm performance (Wijethilake & Ekanayake, 2020) and CEO power and corporate social responsibility (CSR) programs (Duong et al., 2023). Studies have examined the relationship between board composition and environmental disclosure (Raimo et al., 2022), board composition and integrated reporting quality (Chouaib et al., 2022), and board composition and audit risk (Fakhfakh & Jarboui, 2022).
In addition to research on firm outcomes, the role of governance in ethical issues has received a good deal of attention. A special issue of *The Journal of Business Ethics* on Governance and Ethics was published in March of 2023. The issue included a review of recent research that had appeared in the journal (Veldman et al., 2023) as well as fourteen new articles that looked at the future of governance and ethics research. These articles included an examination of topics such as the impact of directors on socially responsible disclosure (Li et al., 2023), CEO compensation and corporate social performance (McGuire et al., 2019), and governance and asset management (Harris et al., 2017). Yet little has been written in this special journal or the literature in general about how to prevent ethical issues from happening.

This study seeks to fill the gap in the literature on ethical lapse prevention. Our research aim is to examine both the board of directors’ power and the CEO’s power and influence on ethical lapses. By taking a broad-stroke approach to ethical lapses, we offer guidance for firms in preventing a host of ethical problems that may impact important outcomes of the organization. In this research, through the paradigm of agency theory, we seek to answer the research questions:

**RQ1:** Is a powerful CEO, who is less controlled by a board of directors, more likely to be associated with ethical lapses?

**RQ2:** Are powerful boards of directors, who have strong oversight of the organization, associated with fewer ethical lapses?

The relevance of this study is to offer guidance to organizations that place a high priority on ethics. By filling this gap, we also offer a significant addition to the governance literature.

We utilized logistic regression analysis to predict whether powerful boards of directors could influence the firm’s ethical lapses. Next, we used logistics regression analysis to predict whether powerful CEOs could also influence the firm’s ethical lapses. The findings indicate that powerful boards of directors can positively influence the firm’s ethical lapses. Specifically, as boards become more powerful, the odds of reducing ethical lapses increase by 66%. Lastly, powerful CEOs do not appear to have any direct effects on reducing ethical lapses. The contribution of this study suggests that firms should create powerful boards if creating an ethical firm is important.

The remainder of the paper is structured as follows. In Section 2, we will offer a review of the relevant literature and present our hypotheses. In Section 3, we present the methodology used to collect and analyze the data. In Section 4 and Section 5, our findings are presented and discussed, respectively. In Section 6, we draw conclusions including the limitations of the research and the future directions.

### 2. Literature Review and Hypotheses Development

#### 2.1. Ethical lapses and firm outcomes

As companies began to embrace the societal interest in ethical organizations, it was often difficult to implement a code of ethics, as many strategies for doing so were expensive. These added expenses were often hard to justify. Then, in 1984, the U.S. Sentencing Commission developed the Sentencing Reform Act, a provision of the Comprehensive Crime Act (United States Sentencing Commissions, n.d.). The Reform Act developed, and in 1987, implemented, the Sentencing Guidelines for firms convicted of ethical lapses. These two developments enabled organizations to justify the expense of operating in an ethical manner.

In addition to the enhanced legal exposure firms faced from an ethical lapse, research began to expose the financial costs of these actions as well. In a study of publicly traded firms between 1989 and 1993, an ethical lapse produced a lower-than-expected stock performance (Rao & Hamilton, 1996). These results suggested to management that unethical behavior was likely to result in financial harm to the organization.

In more recent research, Long et al. (2016) found that firms that had an ethical lapse had significantly lower financial performance as compared to the industry average for five years following the announcement of that lapse. However, they also found that these firms’ stock prices returned to the industry average after five years.

#### 2.2. Good ethical reputations can help

Bae et al. (2020) found that companies with a positive reputation for CSR suffered less reduction in stock price when an ethical lapse occurred. While the ethical lapse did cause some reduction in financial performance, the downturn was less than for those firms that did not start out with a strong reputation. This study also found that post-ethical lapse and engagement in CSR initiatives helped repair the reputational and financial damage done by the ethical lapse.

Similarly, research found that firms with strong CSR had less negative fallout from the announcement of a financial restatement (Wans, 2020). Wans (2020) also found the reverse to be true as well, that firms that do not have an ethically responsible strategy will have much more investor concern from a financial restatement. Research by Chang et al. (2018) further showed that a higher degree of responsible behaviors led to higher returns on assets and returns on equity.

Having a strong ethical strategy does not only protect a firm from harm when problems occur. There is empirical evidence that CSR can lead to enhanced financial performance. For example, the World’s Most Ethical (WME) ranks companies based on overall CSR. In a study of firm value creation, being named to the WME Companies list produced above-normal returns for the firm (Karim et al., 2015). One day after being named to the WME, the research found these enhanced returns.

#### 2.3. Role of leadership and board governance

Developing a strong code of ethics and incorporating that code into the culture of the organization is something that starts at the very top. Leaders who only espouse ethical values will do little to create a culture that values ethics. The leadership of any organization must enact those values and create a tone that members can
understand and follow. Leaders who, by their actions, model ethical behavior have a positive influence on firm performance (Wang et al., 2017). Those who demonstrate a responsible and sustainable orientation create improvements in the firm’s financial and social performance.

Leaders who have created a strong ethical culture and corporate ethics program can enhance the firm’s financial performance (Eisenbeiss et al., 2015). However, leaders also need the support of a board of directors (Schwartz et al., 2005). It should be noted that sometimes, boards need to ensure the ethical behavior of the CEO.

2.4. Competitive landscape

Business has changed greatly over the last three decades. Technology, as an industry, has emerged and grown explosively. New industries have become dominant in many areas: cell phones, computers, the Internet, and social media. Firms have become huge businesses seemingly overnight, often referred to as unicorns (startup valued at $1 billion). The term “born global” is used to describe firms that have international operations at inception. Many of the world’s largest firms have been founded and run by young entrepreneurs. In the haste of trying to grow their businesses, young entrepreneurs have often not concerned themselves with the nuances of ethical business practices. Intentionally or not, they have made mistakes that would be considered ethical lapses. For instance, Google’s attempt to create a digital library, containing all of the world’s books, created quite a backlash when they ignored the need to obtain the permission of the copyright holders (Efrati & Trachtenberg, 2011).

Hyper-competition, which promotes overly aggressive competitor challenges, can cause ethical lapses (Hitt et al., 2017). To gain market dominance in Mexico, Walmart was charged with violating the Foreign Corrupt Practices Act for its actions over a decade. The firm failed to implement an anti-corruption compliance program in its international expansion strategy. To resolve the criminal charges filed by the U.S. Department of Justice, Walmart agreed to pay $282 million (Michaels & Nassauer, 2019).

Another example of hyper-competition was Luckin Coffee. In a scheme to beat Starbucks in the China market, the firm created false financial statements to lure investors (Michaels, 2020). In 2020, Luckin Coffee agreed to pay a penalty of $180 million to settle charges related to defrauding investors (Michaels, 2020).

2.5. Poor decision-making

Sometimes, ethical lapses arise from what appears to be poor decision-making. In these cases, the decision maker simply makes a decision that is unethical on its face. One example is Wells Fargo’s fraudulent account fiasco. In 2020, Wells Fargo agreed to pay $3 billion to settle charges of opening millions of accounts without their customers’ knowledge. The accounts were opened by Wells Fargo employees who were forced to meet unrealistic sales targets (Eisen, 2020).

Another example is the University of Phoenix’s deceptive advertising scheme. In 2019, the university agreed to a settlement with the Federal Trade Commission (FTC). The FTC was investigating the allegation that the institution was engaging in deceptive advertising regarding its ties to large employers. The total fine to the University of Phoenix was $191 million, with $30 million refunded to over one-hundred forty-seven thousand students and the canceling of $141 million in student debt (Chin, 2019).

2.6. The blurred lines of gray ethics

Gray ethics has been defined as choices that are undefined or difficult to define (Bruhn, 2009). Sometimes the decision is between two right answers versus a right or wrong answer. Instead of black or white decision-making, the lines between right and wrong are blurred or gray.

One example is Facebook’s privacy violations. Facebook was fined $5 billion for violating its consumers’ privacy, in a settlement with the FTC. In addition to the fine, the firm was required to change its privacy practices, adjust its corporate structure, and make changes to the CEO’s role (Ryan, 2020). What makes this a gray area is that firms have, for many decades, sold data that they collected on their customers. In recent years, states, the federal government, and foreign countries have been changing what constitutes permissible data sharing (Jolly, 2014; Conger, 2019).

2.7. Board power and CEO power

Researchers have identified a number of board and CEO characteristics that indicate the level of power possessed by each party. For instance, boards gain power from board structure, composition, and ownership (Nahar Abdullah, 2006; Bonazzi & Islam, 2007). Board structure specifically relates to board size, indicating the number of members (Fernandes et al., 2021). Board composition is related to the independence of the board members and whether there are ties to the organization (Eklemet al., 2023). Ownership is related to the stock ownership held by the board members as well as the stockholdings of large investors.

CEOs gain power through tenure, ownership, and board member nominations (Rehman & Hamdan, 2023; Sun, 2022; Johnson et al., 1996; Yan Lam & Kam Lee, 2008; Shakir, 2009; Young & Buchholz, 2002). The goals of gaining more CEO power are fairly obvious: additional tenure, the ability to pursue own agenda, and self-gain. Interestingly, added tenure increases the probability of still more tenure. Extremely powerful CEOs can become entrenched, which may or may not be positive for the organization. As CEOs gain more power, they are able to resist the board’s vigilance activities. They are also able to craft their own strategies and employ decisions without the board’s input or approval. One example is Martha Stewart, who, as the founder of Martha Stewart Living Omnimedia, held over ninety percent of the voting stock of her firm (Rose & Lucchetti, 2002). This gave her control over all company decisions. Another example is Mark Zuckerberg, one of the founders of Meta, who controls a majority of the voting shares of
stock in the firm (Seetharaman, 2015). Again, Mr. Zuckerberg has the final call on all boardroom decisions.

This study seeks to provide evidence of the effects of board and CEO power on the firm’s ethical behaviors. In this study, board power was defined as the board’s ability to effectively supervise, influence, control, and discipline the CEO; and ensure the shareholder’s primary goal of maximizing profits (Finkelstein & Hambrick, 1996). Regarding the board/CEO relationship, a powerful board must be able to effectively influence the CEO and the firm in general, to ensure that their decisions and behaviors are ethical. The powerful board also must be able to control the actions of the CEO if it appears that the firm is diverting from its ethical values and code of conduct. On the other hand, a powerful CEO would be able to pursue strategies that will likely benefit him or her.

2.8. Hypotheses development

Agency theory addresses the problems between shareholders and CEOs, who are engaged to perform work on their behalf. One problem deals with the goal conflict between the shareholders and the CEO (Fernandes et al., 2021; Dalton et al., 1998; Oswald et al., 2009). The other problem deals with risk-sharing and risk tolerance between the parties (Lazarides & Drimpetas, 2008; Eisenhardt, 1989). Under agency theory, the board would need to be highly vigilant to ensure the shareholders’ interests are protected.

Stewardship theory posits that CEOs are motivated to act in the shareholders’ best interests and are willing to put the organization’s interests first (Dalton et al., 1998; Davis et al., 1997). CEOs, acting as stewards, tend to seek greater returns from acting in a cooperative versus self-serving manner (Thomsen, 2004). Stewardship theory would suggest that less board vigilance is needed to monitor the CEO’s activities.

When CEOs are powerful, they can use that power to effectively run the organization, prolong their tenure, and pursue strategies that may benefit them personally (Combs et al., 2007). Powerful CEOs may choose to use their power to make and implement decisions without consideration of the board’s position (Feng et al., 2003; Finkelstein & Hambrick, 1996). Dalton et al. (1998) suggest that when CEOs are too powerful, firm performance is likely to suffer.

In this study, from an agency perspective, it is hypothesized that powerful CEOs are likely to engage in high-risk decisions for the purpose of self-gain (Dalton et al., 1998). These high-risk decisions may lead to stretching the boundaries of what is considered acceptable ethical behaviors within the firm. Therefore, it is hypothesized:

**H1a:** CEO power is negatively related to ethical behaviors within the firm.

From a stewardship perspective it is hypothesized that powerful CEOs are not likely to engage in high-risk decisions for the purpose of self-gain. The CEOs, acting as good stewards, would prefer actions/behaviors that serve the goals of the organizations. It is unlikely that the CEO would engage or allow the firm’s members to participate in unethical behaviors. Therefore, it is hypothesized:

**H1b:** CEO power is positively related to the ethical behaviors within the firm.

It has been posited that vigilance is at the heart of agency theory. To accomplish the task of preserving and protecting the shareholders’ interests, boards must effectively monitor and when necessary, discipline the firm’s top executives. Proponents of agency theory also consider that boards are ultimately responsible for corporate governance and to fulfill that responsibility requires power (Finkelstein et al., 2008). It has been suggested that when boards are not effective monitors, the problem is the balance of power between the board and the top executives (Finkelstein et al., 2008).

As mentioned earlier, ethical lapses can have a detrimental effect on the firm through damaging the firm’s image and performance. Agency theorists have argued that boards should be responsible for the oversight of the firm’s ethics. Boards need to extend their monitoring role to create a culture that promotes integrity and ethical values (Lightle et al., 2009).

Our position is that powerful boards are more likely to engage in strong vigilance of the CEO’s actions. The increased monitoring and supervision will tend to restrict the CEO’s questionable/unethical actions. Therefore, it is hypothesized:

**H2a:** Board power is negatively related to ethical behaviors within the firm.

**H2b:** Board power is positively related to the ethical behaviors within the firm.

3. RESEARCH METHODOLOGY

3.1. Sample

The sample for the study was selected from Fortune 1000 firms, which are the largest (by revenue) American firms. The total number of firms selected was 102 firms: 50 firms were identified as ethical, and 52 firms were identified as experiencing ethical lapses. The time frame of data collection was 2001–2020. The firms in this study represented the following industries: automotive, financial, energy, publishing, retail, wholesale, manufacturing, media, pharmaceuticals, healthcare, and technology. The firm size ranged from 12,000 employees up to 2,300,000 employees.

Data was collected from publicly accessible documents. Proxy statements, 10-K reports, and the firm’s annual reports were all collected when available. Board and CEO power indicators were collected from these resources. An alternative quantitative research analysis could use logistics regression analysis to examine the effects of board and CEO power on the firm’s ethical lapses. Our choice was to use logistics regression to examine the odds of the event occurring.

In deciding which research method to use, both qualitative and quantitative methods could have been used. The qualitative study would utilize interviews of board members and executives on their actions and perceptions before and after the ethical lapses. The transcripts of the interviews could be coded identifying patterns for analysis.
3.2. Measures

A review of the governance literature led to the factors to include in the construction of the CEO power index and the board power index. We chose an extended list of factors to include in each of the indices. Below are the details of the initial development and how the final factors were chosen.

The development of the board of directors power index began with a review of the governance literature related to board power. The following variables were identified: “board size, nonduality, average board tenure, compensation committee, nominating committee, board composition, lead director, committee composition, board member ownership, and large outside ownership” (Gavin, 2012, p. 9).

Boards that are too large or too small can be easily influenced by the CEO (Lee & Carlson, 2007). Nonduality increases CEO monitoring and independence (Finkelstein & D’Aveni, 1994). Boards with less tenure are likely to lack sufficient knowledge and competence to adequately monitor the CEO (McIntyre et al., 2007). Compensation committees have been found to have more effectively control executive compensation and incentives (Petra & Dorata, 2008). Nominating committees increase board independence by selecting new board members without the CEO’s influence. Lead directors increase board independence by setting the board’s meeting agenda and monitoring the board committees’ activities (Lorsch & Zelleke, 2005). Board and committee composition increases independence by reducing the CEO’s influence. Board member ownership and large outside investors are expected to increase the monitoring and vigilance of the top management team (Donker & Zahir, 2008).

The following variables were collected as dichotomous variables (1) if present, (0) if not: nonduality, compensation committee, nominating committee, lead director, and committee independence (committees comprised of only independent directors). Board size was equal to the total number of members of the board. Average tenure was calculated by the total years of all members divided by total members. Composition was calculated as a percentage of independent directors divided by total directors. For both board members and large outside investors, ownership was calculated as the percentage of common stock held by each party.

Dimension reduction, using Statistical Package for the Social Sciences (SPSS), was used to identify how many factors were related to board power. Exploratory factor analysis, using principal components extraction, with varimax rotation, was used on a sample of 353 Fortune 1000 firms, and then reduced to 296 firms because of missing data. Three well-defined factors were identified: board structure, independence, and ownership. Board structure had two variables: board size and composition. Board independence, defined as shielding the board from CEO influence, also had two variables: nonduality and lead director. Ownership had two variables: board member ownership and large investor ownership.

Confirmatory factor analysis, using principal axis factoring, with promax rotation, was used to support the findings of the exploratory factor analysis. The sample, drawing from Fortune 1000 firms, was reduced from 604 cases to 510 cases due to missing data. The confirmatory factor analysis identified the same three factors as the exploratory factor analysis.

Due to the range size of the data, the variables were transformed into low (0), moderate (1), and high (2) categorical variables. Board size, in terms of number of members, was converted as 0–8 (0), 9–11 (1), greater than 12 (2). Composition, in terms of board independence, was converted as 0–86% (0), 86–92% (1), and greater than 92% (2). Lead director was converted as the absence of lead director (0), lead director identified (1), and extensive director responsibilities identified (2). Nonduality was converted as duality (0) and separated CEO and board chair positions (1). Ownership for board members was converted as 0.0% or lower (0), between 1%–9% (1), and more than 10% (2). Ownership for large, outside investors was converted as up to 5% (0), between 5%–25% (1), and more than 25% (2). The final board power score was the addition of the categorical scores for each of the variables.

The CEO index was created in a similar manner. Exploratory factor analysis, using principal components extraction, was conducted on variables identified in the governance literature related to CEO power. These variables included “CEO tenure, CEO-Board Chair duality, CEO ownership, CEO/board member demographic similarity, CEO/board nominations, and classified boards” (Gavin, 2014, p. 51).

CEO tenure increases the CEO’s experience and knowledge giving them expert power and increasing their effectiveness (Finkelstein, 1992; Shakir, 2009). Duality prevents monitoring and increases the CEO’s influence over the board and the firm (Dalton et al., 1999; Lorsch & Zelleke, 2005). CEO/board member similarity and CEO nominations to the board increase the CEO’s relationships and influence (Young & Buchholtz, 2002). Classified boards, if favorable to the CEO, can shield the CEO from attacks (Faleye, 2007).

The sample of 296 Fortune 1000 firms was used in this step. Two factors emerged from the dimension reduction. One factor was identified as entrenchment, and the other factor was identified as structure and influence.

Confirmatory factor analysis, using principal axis factoring, was then used to support the findings from the exploratory analysis. The sample of 510 Fortune 1000 firms was used in this step. Only one factor emerged from the analysis, CEO entrenchment, and was composed of tenure, board member nominations, and ownership.

The CEO data was converted as follows: tenure was converted as 0–4 years (0), between 4–10 years (1), and greater than 10 years (2). Ownership was converted as 0–1% (0), 1%–4.9% (1), and greater than 5% (2). Board nominations were converted as 0–1% (0), 1%–25% (1), and greater than 25% (2). The final CEO power score was the addition of the categorical scores for each of the variables.

The dependent variable was concerned with the ethical behaviors of the firm. Firms were identified as unethical if they had experienced lapses such as Securities and Exchange Commission
(SEC) violations/judgments/finances, worker exploitation, misleading the public regarding policies, selling unsafe products, tax avoidance, human rights abuses, environmental violations, fraud, bribery, and employment practices. Firms were identified as ethical if they were listed in Ethisphere’s “World’s Most Ethical Companies” and had no other published violations.

4. RESULTS

Table 1 shows the results of the correlations, means, and standard deviations of the independent variables. Table 2 shows the results of the hypotheses testing. Logistic regression was used to test the hypotheses. The results include beta, 95% confidence intervals, odds ratio, Hosmer and Lemeshow, Cox and Snell, Nagelkerke, and chi-square data.

Table 1. Correlations, means, and standard deviations

| No. | Variables      | Means | S.D. | 1   | 2   | 3   | 4   | 5   | 6   | 7   | 8   | 9   |
|-----|----------------|-------|------|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|
| 1   | Board size     | 11.07 | 2.41 | -   | -   | -   | -   | -   | -   | -   | -   | -   | -   |
| 2   | Composition    | 0.82  | 0.14 | 0.82 | -   | -   | -   | -   | -   | -   | -   | -   | -   |
| 3   | Nonduality     | 0.39  | 0.49 | -0.01 -0.21 | -   | -   | -   | -   | -   | -   | -   | -   | -   |
| 4   | Board ownership| 3.93  | 18.69 | 0.03 -0.29 | 0.16 | -   | -   | -   | -   | -   | -   | -   | -   |
| 5   | Large investor | 24.34 | 20.69 | 0.08 -0.04 | 0.27** 0.31** | -   | -   | -   | -   | -   | -   | -   | -   |
| 6   | Lead director  | 0.58  | 0.62 | -0.04 0.21 | -0.40** -0.13 | -0.13 | -   | -   | -   | -   | -   | -   | -   |
| 7   | CEO tenure     | 7.66  | 8.26 | -0.01 -0.09 | -0.34** 0.24* | -0.14 -0.09 | -   | -   | -   | -   | -   | -   | -   |
| 8   | CEO ownership  | 4.45  | 14.02 | -0.14 -0.10 | -0.13 0.38** | -0.12 0.01 0.30** | -   | -   | -   | -   | -   | -   | -   |
| 9   | CEO NOM %      | 0.27  | 0.32 | -0.01 0.17 | -0.17 0.12 | -0.13 0.07 0.28** 0.32** | -   | -   | -   | -   | -   | -   | -   |
| 10  | Ethics         | 0.44  | 0.30 | 0.07 0.25 | 0.10 0.15 | -0.04 0.03 -0.23** 0.18 0.23** | -   | -   | -   | -   | -   | -   | -   |

Note: N = 102, * p < 0.05, ** p < 0.01.

Table 2. The hypotheses testing

<table>
<thead>
<tr>
<th>Variables</th>
<th>β</th>
<th>95% confidence interval</th>
<th>EXP (B)</th>
<th>Hosmer &amp; Lemeshow</th>
<th>Cox &amp; Snell</th>
<th>Nagelkerke</th>
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<td>CEO power</td>
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<td>0.03</td>
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<td>Constant</td>
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<td></td>
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<td></td>
</tr>
<tr>
<td>Board power</td>
<td>0.51**</td>
<td>1.22, 2.26</td>
<td>1.66</td>
<td>0.83</td>
<td>0.11</td>
<td>0.15</td>
<td>1.50</td>
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<tr>
<td>Constant</td>
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</table>

Note: N = 102, * p < 0.05, ** p < 0.01.

Hypothesis H1a stated that CEO power was negatively related to the firm’s ethical behavior. The results in Table 2 indicate that although CEO power was negatively related to the firm’s ethical behavior, it was not statistically significant (β = -0.19, p > 0.05). Therefore, H1a was not supported.

Hypothesis H1b stated that CEO power was positively related to the firm’s ethical behavior. The results in Table 2 indicate that CEO power does not lead to higher ethical behavior (β = -0.19, p > 0.05). Therefore, H1b was not supported.

Hypothesis H2a stated that board power was negatively related to the firm’s ethical behaviors. The results in Table 2 indicate that higher board power does lead to higher ethical behaviors (β = 0.51, p < 0.01). Therefore, H2a was not supported.

Hypothesis H2b stated that board power was positively related to the firm’s ethical behaviors. The results in Table 2 indicate that higher board power does lead to higher ethical behaviors (β = 0.51, p < 0.01). Therefore, H2b was supported.

The odds ratio, in Table 2, of board power influencing the firm’s ethical behaviors is 1.66. This implies that every unit increase in board power yields a 66% increase in the odds that the firm will engage in ethical behaviors.

5. DISCUSSION

The results suggest that as boards become more powerful, they influence the firm’s ethical behaviors. First, the board would likely become much more vigilant in its oversight of the CEO and top management team. The board might support the adoption of policies to promote ethical behaviors and insist that the firm’s management conduct ethical training and enact penalties for ethical violations. Such actions would support agency theory, provided that those actions reduced or eliminated harm to the firm, its customers, and other stakeholders.

The results also suggest that as CEOs become more powerful, they do not appear to have any direct influence on the firm’s ethical behaviors. What the results suggest is that as CEOs become more powerful, they decrease the odds of being classified as an ethical firm. As the probability of ethical behavior goes down, the possibility of unethical behavior may increase. Again, this appears to support agency theory and the need for increased oversight.

The outcomes of firms’ unethical behaviors should not be overlooked. When firms put defective products into the marketplace, consumers can be greatly harmed. For instance, defective medical devices, flammable/exploding lithium batteries, and contaminated food products have harmed numerous consumers. Firms that allow data breaches have harmed hundreds of millions of consumers, especially when the firms were previously notified of their lack of security.

If the level of unethical behavior is great enough, which can severely damage the firm’s image, reputation, and financial performance, the resulting harm extends to all stakeholders. For instance, it is very possible that a firm could be forced to close its doors following a great scandal, such as in the case of Arthur Andersen. When firms close their doors following a scandal, employees lose their jobs, investors often lose their investment, suppliers lose customers, and municipalities lose the basis of their economies. Even if the firm does not close its doors, it is not uncommon to merge or
be acquired by another firm. Finally, CEOs and other top management are often replaced following a scandal.

This study provides support that firms/boards should increase vigilance by acquiring more elements of power, such as a majority of independent directors, an optimal board size, separate board chair and CEO roles, a lead director position, providing board member ownership, and attracting large investors.

It is recommended that board composition should be 50% or greater independent (U.S. Securities and Exchange Commission, 2003). This would allow for minimal influence from the CEO and insiders. It would allow the board to set its own agenda and evaluate the CEO without bias.

Boards can determine their size. The key is to have enough board members but not too many. The optimal board size has been suggested to be 8–11 members (Leblanc & Gilles, 2003). Boards that are too large or too small are subject to CEO manipulation.

The lead director position can be initiated to overcome the negative effects of duality. When the CEO is also the Chairman of the Board, board members are prone to manipulation or lack of complete/direct data on which to base decisions. Lead directors also conduct CEO evaluations with just the independent directors. They also set the meeting agendas and conduct the board meetings (Penbera, 2009).

The board can also separate the CEO and board chair roles. This would allow the board to properly monitor and supervise the CEO. It would encourage the board members to speak more openly about the firm and the top management team’s performance, even with the CEO in the room (Elsayed, 2007).

The firm’s stock should be used to compensate the board members. Board ownership puts the board members in the same situation as the stockholders. The board cannot act as disinterested board members if their stock holdings are at risk with every decision or lack of decision they make (Khanchel, 2007).

The firm should also position itself to attract large investors. The presence of large investors, such as institutional investors, can add a higher level of vigilance since they are prone to make their investment decisions strictly based on firm performance. Also, the presence of activist investors tends to mainly accelerate risk-taking and improve firm performance (Khanchel, 2007).

6. CONCLUSION

This study examined the influence of the board of directors’ power and the CEO's power and their effects on the unethical behaviors of the firm. Using a logistics regression analysis, the results appear to support that board power had a direct influence on firm behaviors. Every unit increase in board power yielded a 66% increase in the probability that the firm would engage in ethical behaviors.

On the other hand, the results of this study indicated that CEO power did not have a direct influence on the firm's ethical behavior. This finding might suggest that powerful CEOs do not have either a positive or negative effect on the firm's ethical behaviors.

Following this study, it is recommended that to prevent ethical lapses, boards should increase the characteristics that lead to more powerful boards.

There are some possible limitations that may have influenced the outcomes found within this study. The possible limitations include the generalizability of the results, the data used in the study, the business and economic environment during the timeframe included in the data collection, and other variables that were not accounted for in the study.

The sample included only the largest, publicly owned U.S. firms. One of the principal reasons for only including these firms was the availability of the data. Another consideration for using this sample was the corporate governance structure. Other firms, such as smaller firms, privately held firms, and firms with headquarters in foreign countries may not utilize a similar structure.

Another limitation may be the reliance on archival data. Most of the data was collected and stored by government agencies. Archival data may be collected with less intense scrutiny or fact-checking, which may cause errors in the data. Archival data may also be subject to misinterpretation if it was originally collected for other reasons.

An additional limitation may be the general business and economic environment in which the firms were conducting business. During the specific period from which the data were collected, considerable changes were occurring in the business environment. There were both good and poor economic periods in many business sectors. Since the turn of the century, large corporations have come under intense scrutiny by the public and the government due to many unethical behaviors committed by some of the largest firms in the U.S. In general, large, publicly held firms have had to deal with more regulations than ever contemplated. One such regulation was the Sarbanes-Oxley Act of 2002 (Valenti, 2008). U.S. stock exchanges have also added pressure on publicly held firms to increase board member accountability and independence. Finally, a limitation may be the influence of other variables not identified or used in this study. For example, other board of directors or CEO characteristics may have been studied.

Future research opportunities include focusing on the types or levels of unethical behaviors and the influence of board power and CEO power. Exploring the firm characteristics such as size, geographic scope, and industry type might offer insights into trends and patterns of ethical scandals. Finally, analysis of the outcomes following ethical scandals might influence what actions boards should take to remain vigilant of all firm activities.
REFERENCES


