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ARTICLE

The ethical commitment of independent directors in different contexts of investor protection

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Abstract The purpose of this study is to compare, for countries with different legal environments, the degree to which boards of directors may improve corporate ethical behaviour by designing codes of ethics. These codes address issues such as a company's responsibility regarding the quality of its products and services, compliance with laws and regulations, conflicts of interest, corruption and fraud, and protection of the natural environment. Using a sample of firms from 12 countries, we obtain evidence that a greater presence of independent directors on the board leads to the existence of more complex codes of ethics. Moreover, there are significant differences between countries with high levels and countries with low levels of investor protection as regards the effectiveness of independent directors in constraining unethical behaviour by managers.

Introduction

The effects of scandals involving fraud, corruption, etc. on a company's image, profitability, and long-term survival have heightened the corporate concerns regarding ethics and led to the development and implementation of ethical codes (Fan et al., 2008). These codes contribute to formalizing the corporate values, institutionalizing the guidelines for decision making within the organization, and laying down standards for responsible behaviour (McKinney et al., 2010; Singh, 2011).

Various international agencies and organizations (New York Stock Exchange, 2003; OCDE, 2004) and researchers (García-Sánchez et al., 2008; Rodríguez Domínguez et al., 2009) have considered the role of the board of directors in business ethics. In this sense, this body is responsible for supervising the senior management and for preventing and/or punishing inappropriate behaviour (Schwartz et al., 2005). The need for the involvement and commitment of the senior management and its delegate bodies to ensure the effectiveness of an ethics programme has been specially emphasized (Weaver et al., 1999).

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Among the desirable features of the board's functioning for business ethics, its independence stands out. It ensures greater effectiveness in the control of the senior management (Hermalin and Weisbach, 1988; Zahra and Pearce, 1989). Furthermore, it has a decisive influence on the design of strategies for corporate responsibility (Jo and Harjoto, 2011) and ethical strategies (García-Sánchez et al., 2008). The final goal is to limit managers' opportunities for self-benefit and the high direct costs associated with malpractice, such as fines and prison sentences, as well as negative media exposure and the consequent damage to the firm's reputation (Johnson and Greening, 1999).

On the other hand, Ravina and Sapienza (2010) argued that independent directors are economic agents, whose decisions may be influenced by their own interests. Moreover, they are subject to the institutional environment in which they operate (Bebchuk and Weisbach, 2010), which determines the type and functioning of the control mechanisms (La Porta et al., 2000).

Therefore, previous studies have suggested the importance of the board of directors regarding its active role in ethical practices, its monitoring role, and the relevance of its independence as a positive feature that may encourage stricter ethical behaviour. Based on these premises, this study examines the level of involvement of independent directors in the development of ethical codes. In other words, we attempt to determine whether independent directors promote the implementation of ethics codes addressing a wider range of issues. It also studies whether this involvement varies according to the level of investor protection present in the institutional environment in which the company operates.

Along this line, the level of investor protection is considered to be one of the most important factors among the characteristics of the institutional environment. It may contribute to explaining the presence or absence of opportunistic behaviour by managers (Benos and Weisbach, 2004) and/or their misappropriation of investors' rights (Dyck and Zingales, 2004). Such expropriation or opportunistic behaviour by internal agents can take the form of the personal use of company assets, acquisition strategies that destroy value, accounting manipulation, bribery, corruption, etc. (Morck et al., 1990). However, there is no clear evidence of interaction with the institutional environment that could influence the behaviour of independent directors.

Previous research has produced conflicting results; although a substitutive relationship has been shown to exist between the institutional environment and the characteristics of the board of directors (Aggarwal et al., 2009), many authors have observed a lower degree of opportunistic behaviour by managers, such as accounting manipulation or information asymmetries, in countries where the investor protection is stronger (Ball et al., 2000; Bhattacharya et al., 2003; Leuz et al., 2003; Bushman et al., 2004). On the other hand, there is no empirical evidence of an interaction between the two factors with respect to the design of corporate strategies (Bebchuk and Weisbach, 2010). Therefore, we propose that countries with strong investor protection offer a more suitable context for independent directors in order to implement more complex codes, whereas these directors in countries with less investor protection would face greater reluctance to implement mechanisms that restrain opportunistic behaviour.

Taking these considerations into account, our study makes a new contribution that copes with both perspectives: the importance of the board's independence as a corporate governance mechanism in the implementation of ethics codes and the difference in involvement according to the context in which the company operates.

The two perspectives are combined in the proposal of our research model, in which the scope of ethics codes is expressed as a function of board independence, its interaction with the investor protection existing in the environment, and some control variables. To test this model, we use a panel data sample made up of 5380 observations for an average of 760 companies from 12 countries, for the time period 2003–2009. The financial data were obtained from Compustat, whereas the data on corporate governance and ethics were extracted from the EIRIS database.

Our findings point out that independent directors positively influence the implementation of codes with a wider scope, with an ethical commitment that extends beyond the discrimination and the adequate relationships with providers and clients. This compromise encompasses a wider range of ethical issues, affecting the sustainable use of resources and the overall relationship with society. The findings obtained are in accordance with previous studies (e.g. Ibrahim and Angelidis, 1995; Johnson and Greening, 1999), which emphasize the potential link between board independence and willingness to show the firm's ethical behaviour.

Additionally, we detect that the investor protection existing in the corporate context in which the company operates influences the extent of the impact of independent directors on the development of more complex codes. Hence, directors of companies in countries with a lower level of investor protection have more difficulty in implementing ethical codes with a wider range of contents. This result reinforces the previous evidence found by Beck et al. (2003) or Shen and Chih (2005), which show a complementary link between internal and external mechanisms of corporate governance.

This study is structured as follows. The section ''Ethical codes'' describes ethical codes as a mechanism for combating unethical practices and the importance of the board in ensuring their effectiveness. The section ''The ethical role of independent directors'' contains the main research hypotheses, related to the role played by independent directors in implementing more complex ethical codes and the stronger influence expected in those countries with greater investor protection. The fourth section presents the sample analysed, the variables used to test the hypotheses, and the models proposed. The section ''Empirical analysis'' explains the results obtained after estimating the original models and undertaking some sensitivity analyses, and finally section ''Conclusions'' summarizes and concludes.

Ethical codes

Business ethics can be understood as the set of values, norms, and principles that seek to achieve respect for the rights generally recognized within a society. To institutionalize ethical conduct within corporations, specific codes have