The Effect of Code of Ethics, Sound Corporate Governance in Curbing the Financial Crisis.

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Abstract

The current study aims to examine the effect of a code of ethics, sound corporate governance participate in curbing the financial crisis. This study suggest that symptoms like lack of confidence in stock markets, investor's lack of trust, lack of visibility, all of these symptoms forms the headline of one disease title called financial crisis. The thread that binds these symptoms together in an effort to provide the right cure is an ethical code of conduct and tight corporate governance. A questionnaire has been designed for this purpose, and it was distributed to selected accounting and management employees working in different Jordanian business environments. The number of questionnaires analyzed were (150) questionnaires. Resolution data were analyzed using the statistical program Smart PLS,(Partial Least Square). The study concluded that, a sound corporate governance, and a sound code of ethics can reduce the probability of financial crisis, and can minimize the risk of financial instability.

Keywords: Financial Crisis, Code of Ethics, Corporate Governance.

1. Introduction

Stock market variations, investors' strategies, managers' behavior, and corporate governance are few aspects of the economical culture. The common factor that binds these elements together is ethics. Ethics can be defined as a code of conduct that applies to everyday life. It addresses the question of whether actions are right or wrong [1]. One of the wrong actions of the economic world is the financial crisis that took place in the year of 2007 and still we are suffering its consequences. Everybody agrees that the financial crisis is a result of misbehavior in the first place, rather than to factors such as poor risk controls, and massive leverage. The white paper number 44 of Greycourt & company mentioned that "the root cause of the crisis was the gradual but ultimately complete collapse of ethical behavior across the financial industry" [2]. The evidence from the World Economic Forum study and the available literature establishes that a lack of or absence of ethics and values is at the root of many of the problems facing the global community today [3].

In unpredictable global economy, where there is no straight solution to problems facing humanity, one thing is clear: we should aim at preventing further crises of an economic and social nature [4]. So can ethics play this important role and prevent further financial crisis? In times of crisis, success or survival is driven by a company's ability to use its assets in new and more inventive ways. Ethics is about the goodwill and reputation of both individuals and institutions.

Effective corporate governance structure can also play an important role in preventing or curbing financial crisis. Effective corporate governance improves investor confidence, it ensures corporate accountability, enhances the reliability and quality of public financial information, and enhances the integrity and efficiency of the capital market. Corporate governance is a process affected by legal, regulatory, contractual, and market-based mechanisms and best practices to create substantial shareholder value while protecting the interests of other shareholders [5]. In a capital structure where there is a concentrated ownership and a small group of shareholders can exercise ownership control, corporate governance should ensure alignment of the interests of controlling shareholders with those of minority or individual shareholders [6]. In addition to policies and procedures designed to promote effective corporate governance, organizations must create and reinforce a consistent, positive corporate culture which complements such measures. Members of the organization, starting with the executives, must lead by example in their efforts to encourage others to comply with applicable policies and procedures. The norms and values embraced by the organization as its corporate culture should be consistent with its policies and procedures; otherwise behavior inconsistent with those policies and procedures will result in losing confidence in these corporations [7]. Most of financial scandals occurred during the last decades lead to the raise of regulatory acts trying to reform the firms' accountability structure. The Sarbanes-Oxley act was one of these acts passed intending to restore public confidence in corporate governance. The Sarbanes-Oxley (SOX) act has encouraged management to effectively formulate and implement a strong system of internal control and financial reporting in order to eliminate errors and to prevent fraud.

This research paper will try to aid in curbing the financial crisis through two important tools; ethics and effective corporate governance. Firms should adopt codes of professional conduct, in order to ensure that its members fully understand their responsibilities. Effective corporate governance should also have broader social and institutional dimensions. Properly designed rules of governance should focus on implementing the values of fairness, transparency, accountability, and responsibility to both shareholders and stakeholders. In order to be effectively and ethically governed, businesses need not only good internal governance, but also must operate in a sound business environment.

2. Study Problem

One of the main business failures from the 1980s up to now is due to improper ethical values and weak corporate governance. There is considerable debate about the causes and origin of the global financial crisis, and many debate about the responsibility towards it, so the problem of the research raises the following questions:

1- Is there a weakness in the ethics of those who apply those standards, which led to the emergence of the financial crisis?

2- Is there a weakness in the corporate governance structure, which led to the emergence of the financial crisis?

3. Study Importance

In order to stand on the real causes of the financial crisis, research should cover all aspects of the financial crisis. Two important aspects of the financial crisis are attributed to collapse of ethical behavior and weak corporate governance structure. From the researchers point of view these two factors are very important and it worth discussion.

4. Study Objectives

The current study aims to examine the effect of a code of ethics, sound corporate governance participate in curbing the financial crisis. This research will try to attain the following objectives:

1- Figuring the causes of weak and improper ethics behavior that contributed in the emergence of the financial crisis?

2- Is there an effect of a code of ethics in curbing the financial crisis?

3- Figuring the causes of weak and improper corporate governance structure, which led to the emergence of the financial crisis?

4- Is there an effect of sound corporate governance in curbing the financial crisis?

5. Literature Review

Corporate governance is a set of rules that define the relationship between stakeholders, management, and board of directors of a company and influence how that company is operating. At its most basic level, corporate governance deals with issues that result from the separation of ownership and control. But corporate governance goes beyond simply establishing a clear relationship between shareholders and managers [8]. (CIPE: Development Institute,2013). Corporations should create an ethical culture that encourages all corporate governance participants including directors, officers, auditors, financial advisors, employees, and others to do the right thing and understand that this is vital to the company's sustainable financial performance. Recent research has addressed the gap between public policy and the corporate governance literature in accounting by studying the effectiveness of a code of ethics. The research predicted that a code of ethics will improve manger return behavior and investor confidence to the extent that it activates social norms that control opportunistic behavior. The research found out that when the code is present but there is no certification choice, manager returns behavior does not improve and investor confidence erodes over time because of increased expectations that are not met by managers [9]. Good corporate governance ensures that the business environment is fair and transparent and that companies can be held accountable for their actions. Conversely, weak corporate governance leads to waste, mismanagement, and corruption. It is also important to remember that although corporate governance has emerged as a way to manage modern joint stock corporations it is equally significant in state-owned enterprises, cooperatives, and family businesses. Regardless of the type of venture, only good governance can deliver sustainable good business performance [10,8].

Ethics, sometimes known as philosophical ethics, ethical theory, moral theory, and moral philosophy, is a branch of philosophy that involves systematizing, defending and recommending concepts of right and wrong conduct, often addressing disputes of moral diversity. The term comes from the Greek word ethos, which means "character". Philosophical ethics investigates what is the best way for humans to live, and what kinds of actions are right or wrong in particular circumstances [11].

Professional ethics is a code of conduct that applies to the practice of a profession. Like the ethical conduct of a company, the ethical actions of a profession are a collection of individual actions [12]. It is the responsibility of every person who becomes a member of a firm to uphold the high standards of the profession, regardless of the field the individual enters [13].

Every board should adopt codes of professional conduct, in order to ensure that its members understand the responsibilities of being professional workers. Fundamental to these codes is responsibility to the public, including clients, creditors, investors, and anyone else who relies on this work. In resolving conflicts among these groups, the workers must act with integrity, objectivity, and independently, even to the sacrifice of personal benefit.

Jackling, Philomena & Steven, determined the top nine factors that contributed to ethical failures.The factors include "self-interest, failure to maintain objectivity and independence, inappropriate professional judgment, lack of ethical sensitivity, improper leadership and ill-culture, failure to withstand advocacy threats, lack of competence, lack of organizational and peer support, and lack of professional body support" [14].

The existence of codes of ethics and defined procedures, rule and roles are perceived as supporting higher ethical behavior. Existence of codes also increases perceptions that the organization has a greater concern for ethical behavior. However, codes must be supported by clear accompanying sanctions to be effective [15]. Many companies use the phrase 'code of conduct' to express the values that describe a company's obligation to its stakeholders. The code is publicly available and addressed to anyone with an interest in the company's activities and the way it does business. It includes details of how the company plans to implement its values and vision, as well as guidance to staff on ethical standards and how to achieve them. However, a code of conduct is generally addressed to and intended for employees alone. It usually sets out restrictions on behavior, and will be far more compliance or rules focused than value or principle focused [16,11].

Moral failure played a prominent role in the emergence of the global financial crisis. The greedy behavior of some executives who failed to exercise their work properly, and have deviated from the established objectives in order to achieve personal interests, as well as the greedy behavior among shareholders trying to get quick-gains, financial corruption, conflict of interest, and complex financial instruments, had contributed in the current financial crisis. Also during the past few decades many countries of the world had shifted its economic system to capitalism, as a result of this change; many financial markets collapsed or witnessed financial crises. So there is argent need to tight corporate governance especially in the developing and emerging economies.

Finally, there are several indicators clearly links between, corporate governance, moral concepts and the financial crisis. Al-Qashi & Al-Khateeb in their study, they concluded that both collapse of Enron, and Arthur Andersen are due to professional ethics, Arthur Andersen did double job to Enron, and which was a clear violation to the rules, the financial market authorities was responsible to those collapses due to lack of control, and most of the companies and auditors face difficulties in applying new rules of corporate governance, and main problem is unethical behavior, not in the rules controlling corporate governance [17]. Unethical actions invaded the global financial markets and economic transactions widely. So the presence of strong code of ethics, strong governance standards provides better access to capital and aids economic growth. Corporate governance also has broader social and institutional dimensions. Properly designed rules of governance should focus on implementing the values of fairness, transparency, accountability, and responsibility to both shareholders and stakeholders. In order to be effectively and ethically governed, businesses need not only good internal governance, but also must operate in a sound business environment. Business environment itself should obviously be both the promoter and the beneficiary of corporate governance, properly overtaken and applied, in the broadest sense of leadership the corporate governance gives while covering a lot of meanings, approaches, interests, concerns, and possible solutions [18].

6. Method

The primary data needed for the study objectives were collected through a survey conducted among Different Jordanian companies. A questionnaire has been designed for this purpose, and it was distributed randomly to the working employees taking part in actions and activities on carrying out business in their companies in Feb 2014, and to different managerial levels. The number of questionnaires analyzed were (150) questionnaires. Resolution data were analyzed using the statistical program Smart PLS.

Quantitative data were collected using a self-administered questionnaire, in which the employees were asked to state the likelihood (on a 5-point scale: [5] strongly agree; [4] agree; [3] neutral; [2] disagree; [1] strongly disagree),150 copies of the questionnaire were delivered by hand on the respondents, 144 copies were returned (percentage of 96%); these 144 copies were accepted and used in the pilot analysis of the original distributed copies).

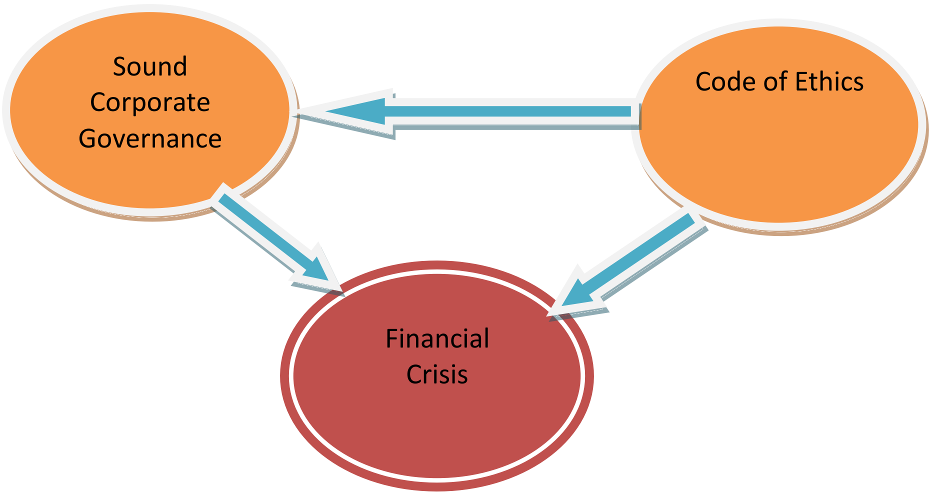
Other Data is collected from secondary sources. Secondary data is collected from articles published by the well-known periodicals, books, and dissertations.

6.1: Statistical Analysis:

The Statistical Package for Social Sciences Smart PLS was applied in analyzing the data received; Statistical Analysis tools include the followings:

1. Descriptive Statistics, mainly frequencies and percentages, were used to analyze sample characteristics according to job, educational level, professional certificates, and experience.
2. Correlation, Inter-correlation, and Path Coefficient were used to analyze and describe study variables from a statistical point.
3. Reliability Test using Cronbach's Alpha was used to test the reliability of the scale.

6.2 Research Design (Exhibit-1)



Research design is formed out of three main elements which constitute the research design. The Model in Exibit-1 shows the effect of code of ethics, and sound corporate governance on the financial crisis.

6.3 Study Hypothesis

H1: There is an effect of a code of ethics in curbing the financial crisis

H2: There is an effect of sound corporate governance in curbing the financial crisis.

6.4 Data Analysis and Findings

6.4.1: Reliability test:

Cronbach's alpha was used to test the internal reliability of the measurement instrument. In this study 0.60 or higher is considered acceptance [19]. As shown in table (2) the Cronbach's Alphas (α) ranged from 0.624 to 0.960, thus establishing the reliability of the survey questionnaire. It is obvious that all values of alpha are high. This indicates that for each measurement of a variable, the items are highly correlated and hence highly consistent. Table (1) shows the Cronbach's alpha for each scale:

Table 1: Cronbachs Alpha

	Cronbachs Alpha
Code of Ethics	0.960855
Financial Crisis	0.624729
Sound Corporate Governance	0.898072

6.4.2 Sample Characteristics

The respondents were 67.4% male and 32.6% female; most of them were between the age of 25 years and 45 years. Most respondents had average experience more than 5 years. The Job title of 46.7% of the respondents were Accountants, 23.9% Accounting officer, Head of accounting department 14.1% and finally 15.2% were Chief financial officers CFO. Most of respondents 70.7% had Accounting degree, JCPA 19.6%, and 9.8% having CPA degree. Demographic data is shown in Table No.(2).

Table No. (2) / Demographics Data for the Pivot Study

Variable	Group	Frequencies	%
Sex	Male	94	65.3
	Female	50	34.7
Total		144	100%
Age	Less than 25 years	12	8.3
	From 26 years—35 years	29	20.1
	More than 36 years—45 years	57	30.6
	More than 46 years	46	31.9
Total		144	100%
Professional Certificate	Master Degree	25	19.6
	PhD	26	9.8
	Bachelors' Degree	93	70.7
Total		144	100%
Job Title	Executive	14	9.7
	Head of Department	33	22.9
	Deputy Manager	38	26.4
	Office Clark	59	41.0
Total		144	100%
Experiences	Less than 5 years	6	4.2
	From 6 years – 10 years	49	34.0
	More than 11 years – 15 years	46	31.9
	More than 16 years	43	29.9
Total		144	100%

6.4.3 Smart PLS Results:

The structural model results are shown in Exhibit 2. Examining the path coefficients; the numbers on the screen enables us to determine, that Code of ethics has the strongest effect on Sound corporate governance (0.943), followed by Code of ethics on Financial Crisis (0.679), and the effect between Sound corporate governance and Financial Crisis was (0.119). Moreover, the three constructs explain 88.9 percent of the variance of the endogenous latent construct Sound corporate governance ($R^2 = 0.889$), and endogenous latent construct Financial Crisis ($R^2 = 0.628$). Table 3 illustrates the r square results.

Model Results: Exhibit-2

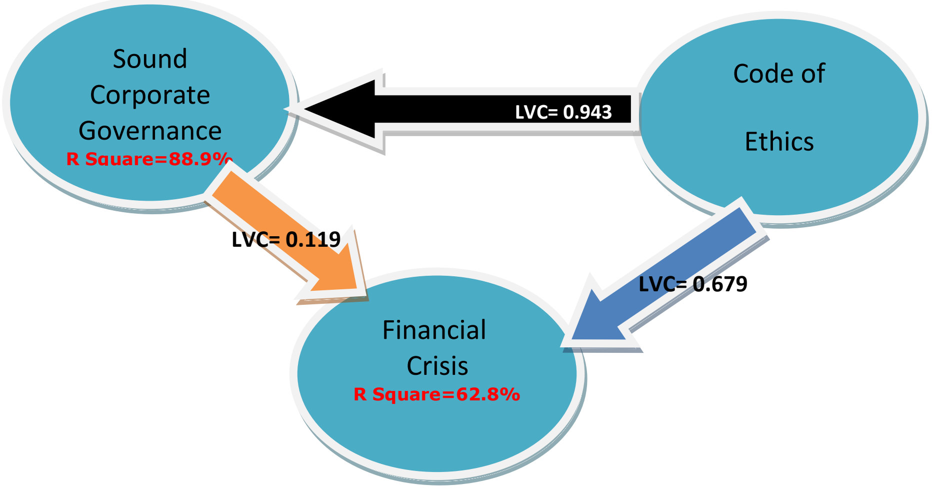


Table-3 the R Square of the Variables

	R Square
Code of Ethics	
Financial Crisis	0.627630
Sound Corporate Governance	0.888811

The results show that the relationship between the three variables is statistically significant. Based on their path coefficient scores, it would appear that the influence of Code of Ethics and Sound corporate governance on Financial Crisis is significant. However, it seems very unlikely that the hypothesized path relationship between Sound corporate governance and Financial Crisis is (0.119) is relatively weak compared to path relationship between Code of Ethics and Sound corporate governance (0.943), and Code of Ethics and Financial Crisis (0.679) but still significant, as the findings of Smart PLS rule explains that the path Coefficient is significant if it is above 0.015.

The convergent validity assessment is associated with the Average Variance Estimated (AVE) value. The evaluation of validity criterion in table 4 illustrates that the AVE values of Code of Ethics (0.578), Sound corporate governance (0.535), and Financial Crisis (0.517) are all above the cutoff point of 0.50. Therefore, all reflective constructs demonstrate high levels of convergent validity [20].

Table 4: Quality Criteria

	AVE	Composite Reliability	R Square	Cronbachs Alpha
Code of Ethics	0.578411	0.964501		0.960855
Financial Crisis	0.517461	0.626008	0.627630	0.624729
Sound Corporate Governance	0.535205	0.914965	0.888811	0.898072

6.5 Conclusions & Recommendations

<u>6.5.1 Conclusions</u>

The results show that the relationship between the three variables is statistically significant. Based on their path coefficient scores, it would appear that the influence of Code of ethics and Sound corporate governance on Financial Crisis is significant, so the research hypothesis stating that Code of ethics and Sound corporate governance affects financial Crisis and makes on limiting its consequences.

Strong code of ethics will have great effect on individual's behavior, financial dealings and eventually, producing quality decision making which will limit manager's misconduct and misbehavior, and participate in curbing the consequences of the financial crisis.

<u>6.5.2 Recommendations</u>

Management should ensure the highest ethical standards embodied in a strong code of conduct that can maintain high ethical performance. Management should also work on strong and tight corporate governance that control ethical behavior and decision making process.

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