Shareholder Preferences Concerning Corporate Ethical Performance

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ABSTRACT. This study surveyed investors to determine the extent to which they preferred ethical behavior to profits and their interest in having information about corporate ethical behavior reported in the corporate annual report. First, investors were asked to determine what penalties should be assessed against employees who engage in profitable, but unethical, behavior. Second, investors were asked about their interest in using the annual report to disclose the ethical performance of the corporation and company officials. Finally, investors were asked if they felt that ethics reports should be audited.

The survey results indicate that many shareholders (42%) do not expect a high level of ethical behavior from corporate employees or officers. There is a significant amount of interest in disclosure of ethical issues (72%) and unwillingness to trust management to provide unbiased reports of ethical behavior. If such reports are included with the financial statements, 32 percent of the investors surveyed would prefer to have them audited to provide independent verification.

The popular press has provided extensive coverage of the Savings and Loan debacle, the Wall Street insider trading scandals and the behavior of legislators who presumably provide oversight but are themselves being accused of unethical dealings. The intensity of the media coverage and the seriousness of the charges have resulted in an increased interest in ethical behavior in all sectors of society.

In 1987, the National Commission on Fraudulent Financial Reporting (The Treadway Commission) recommended including in the financial statements a report in which management formally recognized its responsibility for various aspects of control of the company. One of these elements was assurance that the company had an ethics policy.[1] In 1988, the Securities Exchange Commission (SEC) endorsed the Treadway Commission's report in an exposure draft that would require such a report to be included in the annual report and filings with the SEC.[2] The exposure draft also proposed auditor involvement with this report.

This recommendation must be based, at least in part, on the assumption that information concerning the ethical dimensions of corporations is useful to investors. And, in fact, some investors appear to be making investment decisions which incorporate an ethical component (Irvine, 1987). For instance, numerous mutual funds have successfully distinguished themselves from the competition by making one of their stated investment goals "socially responsible" investing. Other investors are insisting that institutional portfolios in which they have a financial interest must not include investment in South Africa companies or companies which produce tobacco products.

However, other investors may be motivated more strongly by profit potential than by ethical corporate behavior. In fact, many members of Congress, deans of business schools, lawyers, and respondents from various industry groups surveyed by Touche Ross in 1988 ranked concentration on short-term earnings even above cultural and social decay as the greatest threat to business ethics today.

Therefore, this study surveyed investors to determine if they preferred ethical behavior to profits and the extent of their interest in having information about corporate ethical behavior reported in the corporate annual report. Our objective was to assess a pure ethical choice in which investors were asked

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to choose between ethical behavior and profits regardless of the potential benefit or liability to the firm. First, we asked investors to determine what penalties should be assessed against employees who engage in profitable, but unethical, behavior. Second, we surveyed investor interest in using the annual report to disclose the ethical performance of the corporation and company officials. Finally, we attempted to determine if investors believe that ethics reports should be audited.

Our survey results indicate that many shareholders apparently do not expect ethical performance from corporate employees or officers. While there is a significant amount of concern over ethical issues, we document some investor preference for profits over ethical behavior. Investors also seem unwilling to trust management to provide unbiased reports of ethical behavior; instead, if such reports are included with the financial statements, many investors wish them to be audited to provide independent verification.

Corporate support for ethical business practices

Brooks (1989) suggested that corporations are becoming aware of the large costs that can accrue to the "profit only" ethic and are beginning to deemphasize maximization of short-term profits. He attributed this to the influence asserted by special interest groups, increased moral sensitivity of executives and the growing awareness that both the corporation and its executives may be heavily penalized for improper behavior.

There is at least some evidence that corporations do encourage the ethical behavior of employees. Sixty-five percent of the corporate directors and officers included in the Touche Ross survey felt that high ethical standards in a business enterprise strengthen its competitive position. Srodes (1990) reported that as many as 2,000 corporations had written ethics codes for their management, directors, and workers. Labich (1992) notes that over 40 percent of Fortune 1,000 companies hold ethics workshops and seminars and approximately 200 major U.S. corporations have appointed ethics officers.

However, management seems reluctant to formally accept responsibility for ethics policies in the management report. Schiff and May (1991) analyzed financial statements of the 25 largest industrial companies in the Fortune 500 for the years 1985–1990 to determine the extent of voluntary compliance with the inclusion of management reports with the financial statements. They reported that while 23 of the 25 companies were voluntarily providing a management report by 1990, only 46 percent included information about the company's ethics policy. Meanwhile, compliance with all other suggestions for inclusions in the report (except signatures by management) was over 95 percent by 1990.

Reluctance to disclose this information could be due, as Schiff and May suggest, to that fact that it is hard to give reasonable assurance that the company is in compliance with its ethics policies. Alternatively, reluctance to disclose could be due to the perception that shareholders view ethics policies to be detrimental to profits, as suggested by the Touche Ross survey. This is an important question to resolve. Stead *et al.* (1990) suggest that pressures exerted by external stockholders can undermine a firm's attempt to instill ethical behavior in its employees. If some shareholders prefer profits to ethical behavior, then management may find it hard to avoid engaging in unethical practices that enhance short-term profits.

The survey

We surveyed shareholders' views on disclosing ethical corporate behavior as part of a more comprehensive study on shareholders' use of corporate annual reports.[3] During 1990, questionnaires were mailed to approximately 2,300 shareholders throughout the United States. The shareholders were selected at random from a list of corporate shareholders with at least one round lot (100 shares of one stock) on either the New York or American Stock Exchanges. In total, 246 usable responses were reviewed and tabulated. There was no significant difference at the 0.05 level using the Chi-square test for non-response bias for any of the questions. A demographic profile of the respondents is provided in Table I.

The respondents are predominately male due to either the male bias on shareholder lists which typically show "John Jones" as the shareholder of record even when ownership is recorded as "Mr. and

TABLE I
Demographic profile of survey respondents

Characteristic	Percentage of respondents
Male	88%
Female	12%
Age distribution:	
Under 40	39%
40 to 59	37%
Over 59	24%
Highest level of education:	
High school	9%
College coursework	24%
College graduate	34%
Graduate degree	29%
Other	4%
Percent of portfolio (excluding home) invested in stocks:	
Under 10%	25%
10 to 24%	25%
25 to 49%	21%
50 to 75%	18%
Over 75%	11%
Dollar amount invested in common stocks:	
Under $10 000	36%
$10 000 to $24 999	17%
$25 000 to $49 999	15%
$50 000 to $99 999	10%
Over $100 000	22%
Experience or education relating to accounting, finance, investment analysis, financial analysis or stock market investing:	
Yes	48%
No	52%

Mrs. John Jones" or "John and Mary Jones" or the possibility that financial questionnaires are more often responded to by men. Responses from women would most often be due to their being the only name on a stock ownership list. Thus, the results may only represent male investors.

The respondents are well educated with the majority having earned at least a college degree. Evidence of interest in financial reporting is suggested by the fact that 50 percent of the respondents have at least 25 percent of their portfolios invested in stocks with 64 percent investing at least $10,000. At least 48 percent of the respondents may be considered to be informed users of financial information since they indicate that they have had formal education training or been employed in a job which familiarized them with accounting, finance, investment analysis, financial analysis or stock market investing.

The demographic data is comparable to that found in a similar study completed in 1975 by Epstein and the recent study of shareholders completed by the New York Stock Exchange. This random sample of shareholders in all 50 states may be slightly wealthier on average than a representative sample since they were required to own at least one round lot of shares. Thus the smallest shareholders are excluded.

Profits versus ethical performance

In order to assess shareholder attitudes toward corporate ethical behavior, we asked two questions designed to solicit their attitudes toward profiting from improper behavior (see Table II). In the first question we asked participants what they believed should happen to an employee who generates a profit from a business practice which is legal, profitable, and the employee believes to be in the best interests of the corporation, but is considered to be unethical. Although the severity of the unethical act was not specified, only six percent of the respondents indicated that the employee should be terminated. Ninety-four percent of the respondents were willing to allow the employee to continue working for the firm and 42 percent would actually reward the employee for improper behavior.

In an alternate test of investor preferences, we asked respondents to determine what should happen to an employee who engages in business practices which are common to an industry but which are illegal. In this setting, even when an employee is engaging in illegal activities, 81 percent of the respondents would not immediately terminate the employee. In fact, five percent would actually reward the employee and encourage continuation of the illegal behavior.[4] Although there is a sentiment

TABLE II
Shareholder responses to employee unethical behavior

1) What do you believe should be the impact on an employee who performs in a manner that he or she believes is in the best interest of the corporation, produces profit and is legal but is considered to be unethical behavior?

Percentage	Response
5%	Rewarded
37%	Congraduated on producing good results but cautioned on methods
52%	Notified of policy against unethical behavior and terminated if reoccurs
6%	Terminated

2) If a business practice is illegal but common in the industry the employee involved in that practice should be:

Percentage	Response
5%	Rewarded because a profit is produced and the practice should be continued
76%	Instructed to stop the practice immediately even if it would detrimentally affect earnings
19%	Terminated and the practice stopped

for stopping the illegal activity, we cannot be sure that the respondents are really showing concern for ethical behavior; their preference may be due to a concern for legal liability and the impact of violations on long term profitability and survival of the firm.

The results of these two questions indicate that some investors are not really concerned about ethical behavior; instead profits may be more important. These investors seem to be sending the message that profitable unethical behavior may be rewarded. Ethical consideration should be above legal considerations but some investors do not seem to reflect this attitude. Our respondents are more likely to terminate an employee for illegal activities than for unethical behavior.

Reporting on ethical performance through the annual report

Our next goal was to assess the degree of investor interest in using the annual report to provide disclosures concerning the ethical performance of corporations and company officers. The respondents were asked whether they were interested in seeing the company's performance in the area of corporate ethics, among other items, measured and reported on in the annual report (see Table III).

Investors are primarily interested in reports on performance in the areas of product quality (85%) and environmental issues (82%). Both product quality and environmental concerns are associated with liability for a firm, thus these results complement the findings from Table II where investors were more concerned about controlling illegal activities than maintaining ethics at the cost of potential profits.

There is shareholder interest in disclosure of corporate ethics. About 72 percent of our respondents indicate a desire for some disclosure in the area of company involvement in corporate ethics. Consistent with this, when asked if a report on the ethical performance of company officers should be included in the annual report, only 27 percent responded that such a disclosure is inappropriate. However, that percentage increases to fifty-one percent if the disclosure might put the company at a competitive disadvantage. Once again we see evidence consistent with the Touche Ross survey. Ethical concerns should supersede any competitive concerns, yet shareholders seem to be unwilling to disclose such information. Following Stead (1990), it is unrealistic to assume that management will be

TABLE III
Areas where performance should be measured and included, audited or excluded

Area of company involvement	Percentage of respondents indicating			
	Total who want to include	Include, but not audit	Include and audit	Exclude
Product quality	85%	47%	38%	15%
Environmental activities	82%	46%	36%	18%
Corporate ethics	72%	36%	36%	28%
Community involvement	71%	47%	24%	29%
Employee relations	67%	45%	22%	33%
Involvement in South Africa	39%	23%	16%	61%

Ethical performance of officers	Percentage of respondent indicating			
	Include	Indifferent to disclosure	Exclude	Include and audit
Include a report of the ethical conduct of company	50%	23%	27%	47%
Include a report of the ethical conduct of company officers evenif such a report might cause a competitive disadvantage	49%	–	51%	Not asked

completely successful in supporting ethical corporate behavior if shareholders do not consistently support ethical behavior.

Thirty-six percent (50% of those who wish disclosure) of the respondents would prefer audited disclosure of corporate ethics. When ethical performance is more narrowly defined as the ethical conduct of company officers, the percentage of respondents who feel that performance should both be reported and audited rose to 47 percent. Any conclusions as to why these figures should differ is pure conjecture since neither "corporate ethics" or "ethical conduct of company officers" was defined in the survey instrument. However, it is plausible that more respondents might feel that management lacks independence when reporting on corporate officers and would prefer to have the auditors look for violations in this area.

The majority of investors do not feel that management disclosures must be verified by the independent auditors. Thirty-eight percent of the respondents indicate that they would be interested in audited reports in the area of product quality and 36 percent are interested in audited performance reports on environmental activities. Fewer than 25 percent of the survey group are interested in audited reports on any of the other performance areas.

Paying for monitoring

The Touche Ross survey indicated that 35 percent of the respondents did not feel that high ethical standards in a business enterprise strengthen its competitive position. Shareholders in our survey seem to agree (or are at least somewhat unwilling to see funds expended in this area). Shareholders were asked to rank the importance of using corporate funds to monitor ethical performance. Specifically, shareholders were asked to rank the following statement: "Corporations that I invest in should use more company funds to monitor ethical conduct by company personnel."

On average, the respondents rated the importance of using corporate funds to monitor corporate ethical behavior at the midpoint (5.1) of a scale in which 1 indicated most important and 10 indicated least important use of corporate funds. This finding suggests that the shareholders were not especially willing to expend funds to monitor ethical behavior.

When asked to rank preferences for other uses of funds, they indicated more willingness to spend money on pollution controls (3.14) and product quality (3.26). They even ranked those two items higher than paying increased dividends (4.16).

Conclusion

Our findings suggest that some shareholders may be willing to tolerate profitable unethical behavior. However the majority would sacrifice profits for ethical behavior (58%) and most would prefer at least limited disclosure about ethics in the annual report (72%). These preferences must be clearly communicated to management in order to bolster managements' efforts to promote ethical behavior. Although management's propensity for promoting ethical behavior is, in part, a function of individual management preferences, some responsibility for encouraging ethical behavior should belong to the shareholders.

Schiff and May's (1991) analysis of voluntary compliance with the Treadway Commission's recommendations for the management report indicates that management may have only limited interest in providing information on corporate ethics policies to shareholders. This may indicate an unwillingness to make strong assertions to shareholders that ethics is preferred to short-term profits. If this is the case, both the Touche Ross survey and Stead *et al.* (1990) suggest that an environment exists in which ethical business practices are unlikely to survive. One answer to this would be to encourage the SEC to make such disclosures mandatory.

Alternatively, management can take the initiative by voluntarily using the management report to sell the concept that good ethics is good business. However, managers may not be willing to engage in what they perceive to be risky behavior. Therefore, shareholders who support ethical behavior, even at the cost of short-term profits, must make their position known and demonstrate support for managers who encourage such behavior. The potential long-term costs of failure to do so include the increased costs of Federal regulation of public reporting and the very real possibility of lost profits in the long-term.[5]

Notes

[1] The Treadway Commission was formed in 1985 as a joint committee of the American Institute of Certified Public Accountants, the American Accounting Association, the Financial Executives Institute, the Internal Auditors Association and the National Association of Accountants. In 1987, the Commission published recommendations concerning ethics policies. In September of 1992, the Commission published "Internal Control – Integrated Framework; Reporting to External Parties".

[2] The Exposure Draft is pending.

[3] *The Shareholder's Use of Corporate Annual Reports* (Marc J. Epstein and Moses L. Pava, JAI Press, Greenwich, Ct. forthcoming, 1992) summarizes shareholder attitudes toward annual report disclosures, usefulness of annual reports and corporate issues of social, environmental and ethical concern.

[4] A Chi-square test of a contingency table indicated that essentially the same respondents would reward unethical behavior in question one and illegal behavior in question two.

[5] Kenneth Labich (1992 p. 168) reported that the stock of Corning Inc., one of the two corporate parents of Dow Corning, declined by over 15 percent after the breast implant scandal even though the implants represented only 1 percent of Dow Corning revenues and there appeared to be adequate insurance to cover all claims.

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