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Business Ethics - Hindrance or Necessity for Corporate Profitability: An Empirical Corporate Governance Study of US Listed Firms

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Abstract: This corporate governance essay seeks to investigate whether business ethics are a hindrance or necessity for corporate profitability? The research analyzes the antagonistic views dividing the world of business ethics, using GLS panel analysis of 943 listed US firms (2005 -2009). Corporate governance is divided into good and questionable governance; their impact, along with the board of directors' compensation is regressed on pretax income. The results become clearer when controlling for trends in the data, although the model weakens. The results empirically strengthen the arguments that questionable corporate governance has a significant and negative effect on the profitability of the firm; questionable governance hinders profitability. Good corporate governance has a positive but insignificant effect on profitability. The board of directors' compensation has a significant positive effect on profitability. This study extends the agency theory by providing an avenue for dividing governance into good (GCG) and questionable corporate governance (QCG) and empirical examining their effect on corporate profitability; the study coins a new term Questionable Corporate Governance. The research provides empirical results that questionable corporate governance hampers profitability; as a policy, directors should try to marginalize its use. The research empirically reinforces the belief that firms reap the consequences of the ethics they pursue, thus contributing to the literature on the business ethics and profitability schism.

Keywords: Agency theory, Good corporate governance (GCG), Questionable corporate governance (QCG), Corporate profit, Board of director compensation, CSR

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INTRODUCTION

Ethics a Hindrance or Necessity for Corporate Profitability

The corporate skyline is cluttered with many lucrative projects, although thin or even devoid of ethics, excelling in corporate professionalism. Corporate carnage has led to concepts like corporate governance, business ethics, and CSR. Corporate scandals also litter the financial landscape, with the likes of Enron, WorldCom, Tyco, Arthur Anderson, Lehman Brothers, City bank, Merrill Lynch, to mention a few. Corporate governance reforms are a must; otherwise, investors will be smeared with suspicion for generations, as the corporate world history is full of deviant scams, at times under the harmless pretext of earnings management.

Many studies (Bozec & Dia, 2015; Kumar & Zattoni, 2018) have been analyzing the influence of governance on profitability. Still, it remains a focal area of immense concern. Researchers like Pantelică (2008) and Rose (2007) both have their antagonistic views on corporate ethics and profitability; a rift that has divided researchers and corporate strategists in their assumptions, policies and strategies, raising fundamental questions like: is corporate governance devoid of selfish extraction of the benefit at the loss of a nation? Are morals and ethics expendable (Friedman & Friedman, 2010) for the sacred bottom line? Is there a limit to how much corporate greed is ethically acceptable? Do corporate goals justify the means? Or is it Kocher to bent and stretch the grey limits of ethics and morals to propel the corporation into the world of profitability? Seeking answers to these probing questions, the fundamentals of the stakeholder theory, in light of recent literature and data will be analyzed. Thus, the need to empirically address the bipolar schism on business ethics and the sacred bottom line.

Amongst the board of directors' core functions (Kim & Ozdemir, 2014; Kumar & Zattoni, 2018) is to protect and create wealth for shareholders, in compliance with the shareholder theory. Board independence is generally

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considered an essential corporate governance component (Bozec, 2013), but its effect on the firm's performance, is for the most part vague, when controlling for good and questionable governance. Wang (2017) casts a glance of shareholder monopoly to retain corporate control even at the expense of diminishing firm value; minority shareholders thus prefer colluding with the monopolist.

This research highlights the dilemma of corporate governance, prompting the inevitable question: "Are corporate ethics a necessity or hindrance to corporate profitability?" The research augments the literature on the antagonistic views of either side of the spectrum; the empirical results would motivate stakeholders to embark on a quantifiable governance path. This research, (i) classifies governance into good and questionable governance, (ii) tests the impact of good and questionable governance, along with the board of directors' compensation on profitability, (iii) and tries to empirically provide evidence to the debate whether good and questionable corporate ethics necessitate or hamper the profitability of the firm; the research also seeks to examine the influence of the board of directors' compensation on the profitability of the company. The study coins a new term - questionable corporate governance, with the help of which the traditional agency theory can be extended.

Research Question and Hypothesis

The central focus of the research is to analyze the influence of the board of directors and good or bad governance on the profitability of the US firm. More specifically the research seeks to answer the following question: "Do business ethics hinder or improve corporate profits in US - listed firms?" The research tests the hypothesis:

H1: There is a significant effect of the governance practices and board of directors' compensation on the profitability of the firm.

LITERATURE REVIEW

As a result of the Federal Sentencing Guidelines For Organizations (in 1991) and the corporate scams at the beginning of the millennium, businesses started to hire Ethics Officers (Lluka, 2010). Jones and Pollitt (2002) analyzed the factors influencing the Cadbury, Greenbury, Hampel, and Turnbull Committees, and the Company Law Review, in the UK since 1990. The study focused on the impact of these landmark committees, and reviews regarding corporate governance.

Copeland and Weston (1992) give a detailed overview of corporate governance by summarizing the findings of leading studies like Grossman and Hart 1980, DeAngelo and Rice 1983, Linn and McConnell (1983), Dann and DeAngelo (1983), Bradley and Wakeman (1983), Dodd and Warner (1983), Dann and DeAngelo (1985), McDaniel (1986), to mention a few.

Randall K. Morck's (2005) book and subsequent review (2009) in the Journal "Corporate Governance: An International Review", spans the history of corporate governance around the world for the last three centuries. From G7 countries to the emerging markets of India and China, the history of corporate governance is unraveled by leading experts in the field, from Antoin Murphy, Caroline Fohlin, Lloyd Steier, Marco Becht, Julian Franks, to mention a few in addition to Morck. The books present the predominant dispersed capitalism model of ownership, as well as the different forms of controlling shareholder patterns by government, corporate holding, or families.

Machan (2009) explored various theories, including the prime objective of managers – to maximize shareholder wealth. Pantelică (2008) focused on the notion that firms pay the price of their unethical practices, while the good firm is rewarded. Berrone, Surroca & Tribo (2007) analyzed the influence on the bottom line of corporate ethics. Rose (2007), however, concluded that ethics will always remain slave to the bottom line; the study maintains that directors are bound by law to safeguard and pursue the interests of the shareholders. Raelin and Bondy (2013) present an augmented two-layered agency theory that seeks to bind societal interests with those of their shareholders, apart from deeming the need for measuring governance actions with respect to the society. Agency (Sun, 2018) and institutional issues tend to have a significant influence (Mackenzie, Rees, Tatiana, 2013) on corporate decision - making.

Like Green and Lopus (2008), Appelbaum, Vigneault, Walker, and Shapiro (2009) and Potts and Matuszewski (2004) also propagate the need for more than one approach to instill ethics as part of the corporate culture. Companies should adopt a multi-pronged approach to addressing ethics-related issues (Fassin & Rosse, 2009). Appelbaum, Vigneault, Walker, and Shapiro (2009) and Potts and Matuszewski (2004) argue that instilling ethics in employees would help in (good) corporate governance and cultivating public confidence. Turyakira (2018) argues that SMEs in developing nations cannot afford to ignore ethics. Mahboob et al. (2021) extends the concept of risk governance (Sheedy & Griffin, 2018) while introducing a culture of transparency and disclosure amongst all stakeholders, necessitated as a proactive step to avert the next financial crisis.

In countries with strong investor protection, companies with strong corporate governance had higher profits and more dividends (Mitton 2004). In comparison, Dobovtsev and Kolobov (2005) overviewed the state of Russian corporate ethics, concluding that it was somewhat primitive, especially in comparison to the US. Using a sample of Japanese manufacturing firms (1997-2007), Colpan and Yoshikawa (2012) analyzed the influence of governance factors on the performance of the firm; the study highlighted the importance of bonuses in nurturing growth and profitability. The positive relationship between CEO's compensation, profitability, and market value is also reported by Conyon and He (2012), in a Chinese study of public firms for the 2000-2010 period.

Donaldson and Fafaliou (2003) point out that corporate carnage has given birth to business ethics, corporate governance, and CSR movements. While progress has been made, in all reality, the movements have not satisfied the stakeholders. The research stresses the need for a responsive code of practices, and a re-examination of the fundamentals of business operation. Further, many types of research has been conducted on the codes of good governance (Aguilera & Cuervo-Cazurra, 2004; Enrione, Mazza & Zerboni, 2006; Hermes, Zivkov & Postma, 2006; Zattoni & Cuomo, 2008).

Mattingly and Berman (2006), emphasize the need to treat good and bad corporate governance separately, as two different and distinct entities. Researchers (like Cuevas-Rodriguez, Gomez-Meija & Wiseman, 2012; Raelin & Bondy, 2013) have pointed out the need to look beyond the agency theory, as it has limitations; Armitage, Hou, Sarkar, and Talaulicur (2017) voice their concern regarding principal-principal issues in emerging markets. As governance is a core component, it may be bisected into good and questionable corporate governance; further, the board of directors' compensation should not be ignored when analyzing the effect of corporate governance on profitability. However, it should be pointed out that some (Frankforter, Becton, Stanwick, & Coleman, 2012) still vindicate the agency theory.

Use of Questionable Governance

Questionable corporate governance (QCG), a term coined in this study, include unethical, and grey areas of governance. Researchers have long documented governance practices that stretch ethics, benefit from deliberately ambiguously worded codes of ethics, exploitation of loopholes, backdating stock options (Minnick & Zhao 2009), investing in funds that mutual fund managers themselves own (Khorana & Servaes, 2004; Gasper, Massa & Matos, 2006). These questionable practices range from issues of effort allocation to cases of fraudulent behavior such as market timing and late trading (Mahoney 2004; Del Guercio & Tkac 2004). Firms under investigation for backdating stock options (Frankforter, Becton, Stanwick & Coleman, 2012), also tend to have compromised governance overview and remuneration systems. The preference at Taiwanese family-controlled firms to hire low-quality auditors (Hsu, Lin & Tsao, 2018), points to the alleged need for hiding questionable corporate governance. Fransen and LeBaron, (2018) point out the worsening situation of fair renumeration policy from 2013 to 2016 of 1200 S&P Global firms to less than 5%, while in 2016 anti-bribery policy was less than 65%, a human right policy was less than 60%, and efforts to curb child labor very alarmingly below 45%. Even more alarming is their elaborate disclosure of the modern corporate governance slavery. Despite regulators' efforts, even recently, Khan, Kalelkar, Miller, and Sanders, (2018), point out deliberate deviant CFO behavior as they quit a firm to join another, by latently contributing to share volatility of both firms, allegedly benefiting the new joining firm at the expense of the old vacating firm.

Mahboob (2020) argues that good and questionable governance coexist, interacting in a complimentary (codominant) relationship. The study empirically personifies the colluding relationship in the case of board compensation. However, Mahboob (2020) uncover a dominant-recessive relationship in the case of cash dividend payout avoidance - questionable corporate governance purging dividends, in favor of investments. Thus, exhibiting a dynamically changing genetic trait, which conforms to the circumstantial need (Mahboob, 2022).

Lasthuizen, Huberts, and Heres (2011) elaborate on unethical practices while also presenting an integrity topology for checking and classifying ethical violations using primary data for individual organizations. While the research does provide a means to measure unethical behavior, it does not check its impact on profitability.

Mckenzie, Rees, and Tatiana (2013) found that companies listed on the FTSE 4 Good index were inclined out of the threat of expulsion to avoid or diminish questionable governance practices detrimental to the environment.

Rose (2007) was based on the input of 34 active directors from US Fortune 200 companies. It pointed out that directors are not ignorant of ethical issues; rather, they are bound by law to maximize shareholder interests. While greed and corruption have played their roles in corporate scams, it is important to realize that directors are bound to follow corporate law rather than their respective ethical views and inclinations. Thus, corporations, more often than not, pursue the bottom-line agenda, stretching ethical limits, utilizing loopholes, benefiting from ambiguity in the codes of ethics, believing that these questionable governance practices would boost profitability. The board of directors are (Kim & Ozdemir, 2014) required by law – "Investor Protection" to safeguard the interests of shareholders, while striving to create and protect wealth. Likewise, they are also required to follow the "Rule of Law", which they might be treading the grey line while protecting their interests and their clients.

Machan (2009) explored various theories of corporate ethics. The dominant shareholder clearly state that management hired by the shareholders should only be concerned with maximizing shareholder value. The exclusivist view that managers should only, and only be concerned with the bottom line is based on Milton Friedman's theory. Of course, Friedman's theory assumes that managers achieve their goals within the "rules of the game." Deviation from this prime objective takes managers into the domain of public governance. The stakeholder perspective dictates that managers should cater to the interest of all affected parties and individuals. Ralph Nader (Machan, 2009) articulates that since companies were formed by the aristocrat elite (royal family/court), they should cater to the well-being of the populace. Miller-Ahrens-Machan (Machan, 2009) tries to reconcile the two schools of thought; they begin with Friedman's argument that managers should focus on the bottom-line, but at the same time, should also be concerned with other issues.

In a Korean study, Choi, Lee, and Park (2013) found that corporate social responsibility can be maneuvered and manipulated to veil meager earnings. Managerial incentives motivate corporate social initiatives, which are possibly driven by the corporate structure, and business group affiliation. This once again identifies the skewed design of empowered individuals, who pursue questionable corporate governance, under the protection of the legal garb.

These researchers, along with Cuevas-Rodriguez, Gomez-Meija, and Wiseman (2012) argue for the need to revise the traditional agency theory. In this regards Raelin and Bondy's (2013) bisecting of the agency theory into two layers might serve as a reconciliation. The augmented two-layered agency theory does acknowledge the collaboration between shareholders and management at the expense of the society, as the general concept without the societal supportive layer. In this research the negative externalities emitting out of governance, are simply acknowledged as questionable corporate governance.

Use of Good Governance

Good corporate governance, generally issued by stock exchanges and manager associations (Aguilera & Cuerva-Cazurra 2004), are designed to be best practices that address deficiencies (Fernandez-Rodriguez, Gomez-Anson & Cuervo-Garcia 2004), by cultivating a culture (Porta, Lopez, Shleifer, & Vishny, 1999) of transparency (Bozec & Dia, 2015), disclosure and accountability by top managers and directors (Hillier & McColgan, 2006). Further, for the governance system to function efficiently and effectively, auditing must be reliable and trustworthy, while capital markets maintain their competitiveness (Mallin, Mullineux, & Wihlborg 2005). A proponent of quality auditing (Fransen & LeBaron, 2018) exonerate the role of the Big Four Global auditors, as they constitute a self-deterring internal regulator, prior to external reprimand.

Andrew West (2009) explored the debate on morality driving corporate governance models. Schneider (2005) evaluated the progress in the aftermath of the adoption of internationally recognized Standards and Codes (S&C) of financial best practices. More specifically it focuses on how the S&C initiative can be instrumental in preventing financial crisis, especially from the perspective of developing countries. Seeking to proactively avert the next financial disaster, Mahboob et al. (2021) recommends a corporate governance framework of corporate disclosure, transparency, and accountability, in retrospect of extensive corporate governance literature review.

Pantelică's (2008) study focuses on the hypothesis that ethical practices go a long way to establishing the reputation of a company. Unethical companies pay the price of bad reputation, and struggle for survival. The study concludes that ethics form the foundation of corporate reputation. The study identifies some new trends such as being ethically visible in the public, as well as intra-industry cooperation. Recently, Rojas-de-Gracia, Casado-Molina, and Alarcón-Urbistondo (2021) point to the sensitive relationship between share prices, corporate reputation, and integrity, as investor perceptions about deviant firms do matter.

Berrone, Surroca, and Tribo (2007) empirically analyzed the effect of Corporate Ethical Identity (CEI) on the bottom line. The research is based on normative and instrumental theory, stressing the fact that companies with good CEI command more stakeholder satisfaction, which influences the bottom line. The study identifies two aspects of CEI, and distinguishes between them namely,

- Corporate revealed ethics,
- Corporate applied ethics.

Results show that informational worth and stakeholder ethics are influenced by revealed ethics; economic performance cannot be improved by revealed ethics alone; stakeholder satisfaction is positively influenced by applied ethics.

In the aftermath of the Enron fiasco, Bozec and Dia (2015) argue the need to look beyond codes of ethics and market-centric governance. The research suggests the need for an independent boardroom that initiates good governance (Zheng & Kouwenberg, 2019), focused on securing investor rights and cultivating transparency, regardless of shareholder concentration.

The need to look beyond the traditional agency theory (Kumar & Zattoni, 2018), is a common theme in much governance research. Cuevas-Rodriguez, Gomez-Meija and Wiseman (2012), state the need to analyze fiduciary relational concepts like, trust, honesty and loyalty from a behavioral and organizational perspective. Using a neo-institutional framework on listed firms (2002-2009), Ntim and Soobaroyen (2013) document corporate financial performance as a result of corporate governance pursuing corporate social responsibility. The study helps further advance and strengthen the notion that a strong relationship exists between corporate performance and social responsibility. More recently, Sun (2018) while analyzing the 2008 financial fiasco, stressed the need to determine the optimal mix of delta and vega in bank executives' compensation, as the crisis was a consequence of the lucrative vega induced package, metastasizing cancerous risk; however, underpaid CEO leave for more lucrative offers (He, Shaw & Fang 2017), increasing managerial turnover.

Hiltunen, Holopainen, and Li (2021) use a private Finnish case study in the health care sector to demonstrate the positive cordial relationship between ethical compliance and the bottom line. Ayunitha, Sulastri, Fauzi, Sakti, and Nugraha (2020) document as their research found that good corporate governance, has a positive but insignificant effect on the agency cost. Good governance as influenced by the conceptual and real consequences of the agency theory is presented by Raelin and Bondy (2013) as a dual-layered concept. The first-layer depicts the frictional interest between shareholders and managers; this layer of the agency theory seems to be extensively researched and studied. The second-layer shows the supposedly nurturing relationship between shareholders and society; the inefficiencies of this layer stem from the scanty research that plagues the vague proficiency of the first layer. While the recommendations for including the societal perspective into the board's oversight might be considered, terming them within the realm of questionable corporate governance practices should not be ignored.

Lei, Ha, and Le (2019) take the ethics versus profitability argument to an elevated plain to personify their stance. They demonstrate that ethically compliant leadership cultivates innovation in the case of over a hundred Vietnamese companies. Moving beyond the traditional bottom - line analysis, the study highlights strategic benefits of ethical business leadership - radical and incremental innovation.

Board of Directors' Compensation

The board of directors' compensation has received a lot of attention worldwide (Boyd, Santos & Shen, 2012); with arguments for, and against over - paid, and underpaid. In America, the Troubled Asset Relief Program (TARP) is designed to be a guideline for compensation packages, while regulatory agencies have developed scavenging mechanisms to diminish directors' compensation; Chinese bank executives have seen their bonuses restricted.

In the quest of discovering the construct of a good boardroom, Berghe and Levrau (2004) criticize the traditional academic approach based on a small set of mundane characteristics. Their field research identifies soft characteristics, which are missing in both literature and governance rankings. Whether these soft traits are adequate or not, the study highlights the nonexistence of many elements.

In the aftermath of the corporate scandal (Chhaochharia & Grinstein, 2009), American stock exchanges implemented new regulation for better corporate governance (Zheng & Kouwenberg, 2019), emanating from the board room. Affected companies' CEO renumeration was more battered than those that were less affected. More specifically, those trouble companies with a relatively small percentage of institutional investors, and no outside directors. Thus, evidence suggests that CEO compensation have been affected, in the case of troubled companies, as the result of the new regulations. Nevertheless, Sun (2018) argued the need to further examine bankers' executive delta and vega incentives to stall risk-infested (mortgage) initiatives, focusing more on performance sensitivity. On the other hand, underpaying CEOs (He, Shaw & Fang, 2017) only increases turnover in constricted labor supply and demand-pull environment.

The bargaining framework of Ryan and Wiggins (2004) can be used to describe the director's compensational horizon. The study concludes that shareholder interests are better served by independent directors who have negotiating leverage over the CEO, at least from a compensation perspective. Compensational rewards to directors for oversight are less motivated, as the CEO control over the boardroom increases. Equity-based director remuneration is more common for companies with more outsider directors. On the contrary, companies with entrenched CEOs, and more inside directors prefer more cash-based remuneration.

In a study aiming to extend the contextual arena of the traditional agency theory, Cuevas-Rodriguez, Gomez-Meija, and Wiseman (2012) propose a more robust and comprehensive remuneration package for executives and directors. Colpan and Yoshikawa (2012) also confirmed the positive relationship between bonuses, and corporate profitability (and growth) in the Japanese manufacturing context. In another Japanese study, Sakawa, Moriyama, and Watanabel (2012) found incentive-based remuneration to be more effective for firms with more foreign investors. Similarly, Conyon and He (2012) also reported a positive relationship between CEO compensation, company profitability and market capitalization.

However, our concern is that in light of the corporate governance (good or questionable), how does it influence the profitability of the firm. The Upper Echelons (Hambrick & Mason, 1984; Hamid, Jam, & Mehmood, 2019; Geletkanycz, Sanders, Gerard, 2012) provides a perspective that establishes the link between directors' rewards and corporate profitability. GarcíaSánchez and García Meca (2018) revitalize the link between managerial skills and investment decisions. Sun (2018), while analyzing the pre-2008 financial crisis, blamed bankers' compensation vega packages, which induced risky initiatives; compensation delta packages improved financial institutions' performance. Thus, the need to draft an optimal package.

METHODOLOGY

Data and Variable Description

The research uses these three sources to make (an augmented) balanced panel dataset of 943 North American listed companies, during the period of 2005 to 2009 (with a sample size of 4,715): (i) Standard and Poors' Execucomp, (ii) Compustat Annual Financial database, and (iii) KLD Social Rating. The augmented data set contained the following variables: Pre-tax income (PI), Total annual directors' Remuneration (COMP), Good Corporate Governance (GCG), and Questionable Corporate Governance (QCG). The resulting balanced panel data set represents about 17% to 21% of listed US companies during the 2005 -2009 period.

From the KLD database six corporate governance strengths for each firm with positive integer points, namely,

- Community,
- Employee relations,
- Human rights,
- Product,
- Environmental,
- Corporate governance,

were aggregated into the variable good corporate governance. Likewise, ten corporate governance concerns for each firm with positive integer points were aggregated into questionable corporate governance. The ten governance concerns are:

- Human rights,
- Product,
- Corporate governance,
- Environmental,

- Alcohol,
- Tobacco,
- Gambling,
- Firearms,
- Military,
- Nuclear.

From the Standard and Poors' Execucomp database the total annual directors' remuneration (COMP), is the total remuneration (salary, bonus and other perks) of all the executives (director, CEO or CFO) in a year for a firm, are denoted by "COMP". Pretax-income (PI) of a firm, taken from Compustat Annual Financial database, is the net income before the deduction of (income) tax. During the five-year period additional financial data (from Compustat Annual Financial database) for the firms in the dataset, such as sales revenue, tax investment, net income, are included in the descriptive analysis only to provide a better corporate insight. However, they are not included in any equations or panel analysis models.

Balanced Panel Analysis Pretests

Before commencing panel analysis, the following tests are conducted:

- Multicollinearity,
- Breusch-pagan LM,
- Hausman test.

Multicollinearity: The variance inflation factor (VIF) between all variables of the model was checked to be well below the ten thresholds and tabulated in Table 4 Thus, in line with previous econometric (Gujrati, 2004; 2011) panel data collinearity is less of an issue.

Breusch-pagan LM test: The Breusch-Pagan LM test was conducted on both models Table 4, indicating a preference for GLS estimates. The null hypotheses were rejected, indicating significant variance (vi) across the cross-sections, representing firms, with a chi-square value of 4,116.39 and 383.877, warranting the Hausman test to probe preference for fixed or random effect estimation.

Hausman test: The consistency of the GLS model is probed by the Hausman test (Hausman 1978). The Hausman test indicated that a fixed-effect model Table 4 would be more consistent (with a chi-squared value of 214.11 at a significance level of less than 1%), as per the equation:

$$Y_{\text{it}} = X_{it}\beta_1 + X_{it}\beta_2 + X_{it}\beta_3 + u_{it} \tag{1}$$

Where y_{it} is the dependent variable - pretax-income during the period t for the firm $_i$ (cross-sections); X_{it} is a vector of independent variables for the period *t* and firm *i*; $\beta 1$ is a *k* x 1 vector of parameters, U_{it} and is an error or distribution term specific to *i* firms in time period *t*.

For a fixed - effect model, the unitary pooled error term (U_{it}) is decomposed into a unit specific and time - invariant component (α_i) and ε_{it} - an observational specific error:

$$\mathrm{y}_{it} = \mathrm{X}_{it}\beta_1 + \alpha_{ij} + \varepsilon_{it} \tag{2}$$

U_{it} Eq 1 is decomposed into a unit-specific and time-invariant component α_i, and an observation-specific error ε_{it}.

When estimating unit-specific y-interests, the$\alpha$is are considered fixed parameters. Thus, the group effect hypothesis is not tested in fixed-effect models; estimation of the remaining parameters is made. As a result, the effect of time - invariant regressors are ignored. For random effect (model 2), U_{it} (Eq 1) is decomposed into:

$$y_{it} = X_{it}\beta_1 + X_{it}\beta_2 + X_{it}\beta_3 + V_i + \varepsilon_{it} \tag{3}$$

Unlike the fixed - effect model, the vis are treated as random possibilities for a probability distribution.

Panel Analysis Using GLS

Since the assumptions of the Gauss-Markov theorem are not likely to be met in the panel data set (Baltagi, 1995), using OLS would be inappropriate for analysis. Further panel analysis is superior in estimation over simple cross-sections or time series (Gujrati, 2004; 2011), while minimizing the bias into broad aggregates arising due to aggregation of the firms. Generalized Least Squares (GLS) would provide greater efficiency, especially considering the covariance structure of the error terms (Gujrati, 2004; 2011), as it is the most appropriate in the situation. GLS panel analysis tends to be more informative and variable, with more degrees of freedom and fewer collinearity issues (Gujrati, 2004; 2011); it is more apt to analyze the dynamics of changes that arise due to repetition of cross-sectional observations. Nevertheless, one must know the limitations, and drawbacks of panel analysis; fortunately, the analysis only includes three independent variables.

The effect of corporate governance on profitability was tested by taking the three corporate governance variables:

- The board of directors' compensation (COMP),
- GCG,
- QCG,

As the regressors, and pretax income as the regress and using two-way GLS fixed - effect (as determined in Eq 2):

$$PI_{it} = \alpha_i + GCG_{it}\beta_{GCG} + QCG_{it}\beta_{QCG} + COMP_{it}\beta_{COMP} + \varepsilon_{it} \tag{4}$$

The X_it and βs of Eq 2 are replaced by the respective independent variables, GCG, QCG, and COMP, as given in Eq 4. The dependent y_{it} is replaced by PI_{it}. Eq 4 can be replaced with the respective coefficients, and rewritten as (Eq 5):

$$\text{PI} = 562,090,411.5 + 12,788,738.2(\text{GCG}) - 92,601,613.3(\text{QCG}) + 15.5(\text{COMP}) \tag{5}$$

Although the data is a micro-set spanning only five time periods, the model's efficiency can be improved by detrending the data at the first difference. This would help remove any suspiciousness about spurious coefficients that may exist because of a latent trend. Thus, the equation at I(I) using GLS-random effect (as determined in Eq 3; Table 4):

$$PI_{it} = v_i + GCG_{it}\beta_{GCG} + QCG_{it}\beta_{QCG} + COMP_{it}\beta_{\text{comp}} + \varepsilon_{it} \tag{6}$$

Eq 6 can be replaced with the respective coefficients and rewritten as (Eq 7):

$$\text{PI} = -19,196,257.3 + 46,761,706.7(\text{GCG}) - 115,752,837.5(\text{QCG}) + 8.9(\text{COMP}) \tag{7}$$

Both models point to the same results, with different coefficients: GCG has an insignificant but positive effect, QCG has a significant negative effect, while the board of directors' compensation has a significant and positive effect on pretax income. However, model 2 (Eq 6) is a weak one, but it serves its purpose of eliminating the effect of trend, and providing further clarity to the results of model 1.

A word of caution is necessary between Eq 4 (fixed-effect model), and 6 (random effect model). Eq 4, like all fixed-effect models has its own intercept for each cross-sectional unit; this is true for all N values, across all N cross-sectional firms. On the other hand, in Eq 6, the mean value of all the firms (cross sections) is represented by the intercept vi, while i is unobserved or latent (Gujrati, 2004; 2011). Due to the loss of a time period in detrending the data, random-effect would be more efficient than fixed-effect, especially given the large sample size (Gujrati 2004; 2011).

Empirical Scrutiny

In addition to all mentioned empirical scrutiny, the Heterosexuality-free model would have further strengthened the results. However, since both GCG and QCG variables have multiple zero values, expelling them from the model would leave only a univariate model with the board of directors' compensation. Further, zero values also represent the bottom of the corporate governance spectrum. Thus, the estimation would be inappropriate given the nature of the data, and possible navigation with an unrepresentative sample into spurious regression terrain.

However, the LOESS graphical analysis of the linear relationship between the firm's profitability and the board compensation are exhibited in Fig 1. The curved slope is somewhat kinked; the relationship initially seems relatively more towards the inelastic side for most firms, and more towards the elastic spectrum in its second half for the minority few organizations with more profits and compensation.

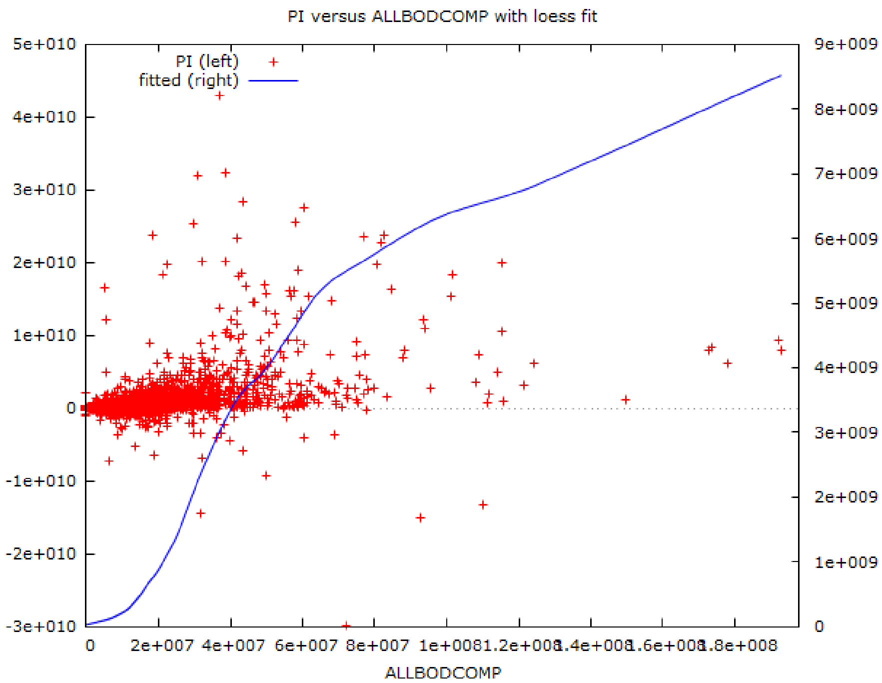

Figure 1: Linear relationship of board compensation & firm's profitability (Author's estimation)

RESULTS

Descriptive Data Summary

The balanced data set spanned five-years from 2005 to 2009 (inclusive), with 943 firms (cross-section, for a total number of 4,715 observations; the descriptive statistics are given in Table 1, 2, and 3.

Table 1: Corporate governance descriptive statistics

	GCG	QCG	COMPENSATION (US $)
Mean	1.11	1.518	13,596,820
Median	1	1	9,143,186
Maximum	15	14	192,925,457
Minimum	0	0	0
Observations	4,715	4,715	4,715

**Authors' estimation

Over the five-year period, listed US firms paid a total of over $ 64 billion to the board of directors, who used more questionable (60%) than good governance policies, to earn revenue of over $ 31 trillion, reported earnings before interest and tax of slightly less than $ 4 trillion, with pretax income of slightly over $ 3 trillion, and profitability (net income) of over $ 2 trillion, paying slightly less than a trillion in corporate taxes.

Mean Descriptive Data Summary

The average listed company has a market value of, $ 8.5 billion, total revenue of $ 6.6 billion, invested capital $ 5.4 billion, dividends of $ 99 million, earnings before interest and tax of $ 819 million, net income of $ 435 million, pretax income of $ 646 million, paid corporate taxes $ 211 million, in an economy with a GDP of $ 13.6 trillion approximately (in a year). The average listed firm engaged in more questionable governance practices than good governance practices, pays about $ 13.6 million as governance compensation to all the boards of directors annually.

Thus, as a percentage of the average GDP, the average US-listed firm is worth about 6%, with total sales of about 5%, and about 4% of invested capital. In retrospect of these figures, the average dividend (of $ 99 million) would seem insignificant.

Table 2: Corporate descriptive statistics (US$)

	MC ($)	REVT ($)	ICAPT ($)	DVT ($)
Mean	8,477,712,036	6,609,928,069	5,395,357,983	99,142,608
Median	1,978,411,700	1,669,963,000	1,310,506,000	999,000
Maximum	382,421,000,000	255,112,000,000	502,274,000,000	10,769,000,000
Minimum	11,240,500	3,919,000	-558,500,000	0
Observations	4,715	4,715	4,715	4,715

**Authors' estimation

Table 3: Profitability descriptive statistics (US$)

	EBIT ($) NI ($) PI ($)		
Mean	819,000,000	435,000,000	646,000,000
Median	169,000,000	86,547,000	130,000,000
Maximum	50,400,000,000	23,900,000,000	43,100,000,000
Minimum	-8,850,000,000	-29,600,000,000	-29,900,000,000
Observations	4,715	4,715	4,715

**Authors' estimation

Maximum Descriptive Data Summary

The biggest listed US firms company had a market value of, $ 382 billion, total revenue of over a quarter trillion dollars, with invested capital of over half a trillion dollars, dividends of under 11 billion, earnings before interest and tax of slightly over $ 50 billion, net income of $ 24 billion, pretax income of $ 43 billion, paid corporate taxes of over $ 19 billion, in an economy with a GDP of $ 14.2 trillion, while paying $ 193 million as governance compensation to all the boards of directors annually, while engaging the 15 good and 14 questionable governance practices. Thus, as a percentage of the highest GDP, the biggest US-listed firms are worth about 27%, with total sales of about 18%, and about 35% of invested capital.

Minimum Descriptive Data Summary

The worst listed US firms (in the dataset) had a market value of only $ 11 million, the sales revenue of $ 4 million, borrowed slightly over half a billion dollars for investment, paid no dividend, and reported losses of $ 30 million, while engaging in no good or questionable governance practice.

Table 4: Business ethics-hindrance or necessity for corporate survival

Dependent Variable: PI	Model 1 (Fixed-Effect)				Model 2 (Random-Effect)		
Independent Variables	Coefficient	T-Stats		VIF	Coefficient	T-Stats	
GCG	12.789 m	0.397	†	1.3	46.762 m	0.959	†
QCG	-92.602 m	-2.635	*	1.4	-115.753 m	-2.333	**
Compensation (COMP)	15.445	6.840	*	1.3	8.896	3.498	*
Constant	562.09 m	7.707	*		-19.196 m	-0.706	
Time Periods	5				4		
Cross-sections	943				943		
Observations	4,715				3,772		

Table 4 Continue.....

Dependent Variable: PI	Model 1 (Fixed-Effect)		Model 2 (Random-Effect)	
Adjusted R-squared	0.790		0.005	
F-Stats	19.683	*	7.934	*
Breusch-Pagan LM test	4,116.39	*	383.877	*
Hausman test	214.44	*	4.01	†

* &** indicate significance at 1 & 5% level. † Indicates insignificance at more than 10% level; millions of US dollars are denoted by "m".

ANALYSIS

GCG has a positive but an insignificant effect on the profitability of the firm. However, QCG has a significant negative effect on profitability. Thus, it is evident that questionable corporate governance negatively affects the profitability of the firm. The effect of GCG improves by a factor of about four times, but remains insignificant, between model 1 and 2, while the negative effect of QCG diminishes somewhat, and the aggregate board of directors' compensation approximately halves.

Pantelică (2008) argued that ethical practices set the foundation of long-term success for the organization. This notion is somewhat challenged by the research findings. Good corporate governance had a positive but insignificant effect on corporate profitability. Had the results been positive and significant, wholeheartedly endorsing Pantelică (2008) would not have been an issue of concern. The detrended Eq 6 does further increase the GCG coefficient, but still well out of the acceptable significant range. Perhaps good governance allows for an improved control under normal circumstances (Alonso-Pauli, 2007; Alonso-Pauli & Perez-Castrillo, 2008), but in tough and trying circumstances, especially in the presence of global competition, managers have less maneuverability and flexibility to address rapidly changing circumstances. Thus, Alonso-Pauli (2007) and Alonso-Pauli & Perez-Castrillo (2008) recommended good governance in markets with minimal volatility, preferable in the meek competition scenarios. Nevertheless, it does raise concerns that questionable governance might be overshadowing good governance. The positive but insignificant effect of good governance also seems to support the perception of the directors in Rose's research (2007), that good governance would yield positive results, yet they would be insignificantly contributing to the bottom line; thus, their reliance on questionable governance practices.

The empirical finding of this research would endorse Pantelică's (2008) arguments that bad ethical practices reflected poorly on the firm's reputation, which melts customer confidence, and eventually results in difficult times for the firm. This could possibly explain why 90% of Fortune 500 companies have codes of ethics.

Rose's (2007) argument that managers are legally bound to maximize shareholder interests, and engage in questionable practices by exploiting loopholes, and ambiguous codes of ethics, in the belief that their pursuit would be beneficial to the sacred bottom line is challenged. The panel analysis clearly establishes a negative relationship between questionable corporate governance and profitability; the results further strengthened by reanalyzing after controlling for a possible latent trend.

The notion of questionable corporate governance hampering profitability, and allegedly diminishing the influence of good governance to a mere insignificance, seems to be in line with the layered agency theory (Raelin & Bondy, 2013). Thus, the need once again to bind societal interests with those of the shareholders. Mackenzie, Rees, and Tatiana (2013) suggested that regulators should be encouraged to enact regulation to bind environmental protection to index listing requirements. From a firm's perspective, Bozec and Dia (2015), propose keeping the firms' management in check by pursuing good governance practices, which may be operationally possible by clawback provision (Lin, 2017), specifically for over-investment or misleading financial reporting.

Of the three governance variables, the board of directors' compensation significantly and positively affects the profitability of the firm. The WLS results are strengthened by the LOESS analysis. In line with previous research (Cordeiro, Veliyath, & Romal, 2007; Cuevas-Rodriguiz, Gomez-Meija, and Wiseman, 2012; Colpan & Yoshikawa, 2012; Conyon & He, 2012), an increase in the board of directors' compensation packages can serve as a motivational factor that results in a significant increase in corporate profitability; however, this will raise many regulatory eyebrows (Boyd, Santos & Shen, 2012) in many countries such as Australia, China, India, the USA, and the UK. Further, emerging market such as Malaysia and Thailand (Al Mamun & Badir, 2013) also support the notion that the board of directors have a significant value addition efficiency effect on the corporate resources.

Nevertheless, the shape of the LOESS analysis reveals that initially for firms in financial distress rewards directors aggressively as the profitability improves (and vice-versa); however after corporate profitability improves, the rewards structure of remunerating directors becomes more elastic.

A word of caution is necessary as studies (Coffee 2005; Denis, Hanouna & Sarin, 2006) do show that considerable increase in compensation, especially stock options (Boumosleh, 2009), could lead to unethical earnings management; unethical behavior increase when the management also constitutes the board of directors. Frankforter, Becton, Stanwick, and Coleman (2012) found generous CEO packages along with a compromised governance that used backdating of stock options. These concerns might be reconciled by using EVA (Economic Value Added) to judge the performance of the management (Stewart, 1991), along with some other (Frankforter, Becton, Stanwick & Coleman, 2012) curbing procedures (like more frequent meetings and more compensational committee members). Further, managerial compensation should also consider prevailing managerial labor market supply and demand factors (He, Shaw & Fang, 2017). The effectiveness of compensation committees is reportedly improved (Sakawa, Moriyama, & Watanabel, 2012) in the Japanese context where foreign ownership is more. Nevertheless, the compensation of the board of directors should motivate their participation in the strategic decision-making process, although the empirical results (Ghaya, 2013) are somewhat murky. But a word of caution is necessary, as it quite possible for managers (Choi, Lee & Park, 2013) to pursue corporate social responsibility, just so as to hide pathetic earnings. In this regard, Geletkanycz, Sanders and Gerard (2012), from an Upper Echelons perspective suggest that the firms interested must be held sacred, while dealing with the challenge of drafting directors' remuneration rewards that would be effective by senior management standards. Entrenched and powerful CEOs (Ryan & Wiggins, 2004) tend to sting the director compensational reward motivation for monitoring and controlling.

CONCLUSION

Good corporate governance has a positive but insignificant effect on the profitability of the firm; it seems that our findings are echoed by Ayunitha, Sulastri, Fauzi, Sakti, and Nugraha (2020), although it is a somewhat different study. Stepping out of the traditional agency theory, and analyzing honesty, loyalty and trust in agent's behavior (Cuevas-Rodriguez, Gomez-Meija & Wiseman, 2012) from a behavioral and organizational perspective, may be a step in the right direction; good governance (Bozec & Zia, 2014; Zheng & Kouwenberg, 2019) also keeps management in check as they strive to pursue shareholder interests. The negative empirical influence of questionable and unethical practices on profitability is clear; Turyakira (2018), did voice concern for SME in developing countries to steer clear of ethics violation. Thus, corporation should avoid questionable and unethical practices, consider good governance practices, such as clawback provisions (Lin 2017), while realizing the positive implications of enhancing (Cordeiro, Veliyath, & Romal, 2007; Cuevas-Rodriguiz, Gomez-Meija & Wiseman, 2012; Colpan & Yoshikawa, 2012; Conyon & He, 2012) the board of directors' remuneration packages. The empirical results address the often-debated link (Bozec, 2013) between directors' compensation and profitability. As the profitability of firms improves, directors' renumeration is more elastic, while as financial distress worsens, directors' package nosedive more inelastically (and vice-versa). From the perspective of well-governed firms (Ntim & Soobaroyen, 2013) that pursue corporate social responsibility, also exhibit sound financial performance. The empirical results seem to validate Wang and Chen's (2017) findings that local and foreign investors in China prefer to invest in firms engaged in pursuing societal and environmental good. In the online digital era, firms risking their reputation may experience (Rojas-de-Gracia, Casado-Molina, & Alarcón-Urbistondo, 2021) their share prices sliding or even nose-diving. Good corporate governance may constitute the fundamental ingredient for higher level radical and incremental innovation, mediated by tacit and explicit knowledge sharing (Lei, Ha, & Le, 2019).

The research clearly points out that good ethics are necessary (Pantelică, 2008; Bozec & Dia, 2015; Zheng & Kouwenberg, 2019; Sadiq, Singh, Raza, & Mohamad, 2020) for corporate survival, while bad or questionable ethics and governance are a hindrance. What is surprising, is that firms use questionable ethical practices with the notion that will be to its strategic advantage. Perhaps deviant managerial behavior may be emanating from individual selfishness, and naïvely influencing firms, considering the implications of Khan, Kalelkar, Miller, and Sanders (2018). Thus, the prevailing notion of using questionable governance to bolster the bottom-line is empirically challenged. Directors feel that it is their legal prerogative in the best interest of the shareholder to engage in questionable governance practices. Little wonder 60% of corporate governance is questionable. When questionable corporate governance gets out of control, it may precipitate in corporate scandals.

RECOMMENDATIONS

In line with Pantelică's (2008) argument, directors should change their perception and underlying strategies and policies regarding questionable corporate governance, since they damage the profitability and the reputation of the firm. Ethical practices help establish the long-term platform for success of an organization (Pantelică 2008). Retention of tacit and explicit knowledge sharing (Lei, Ha, & Le, 2019) which lead to innovation are intrinsic benefit of good corporate governance. A corporate ethical culture of timely disclosure and transparency (Bozec & Dia, 2015; Gugler & Yourtoglu 2003; Hillier & McColgan, 2006; Jam, Singh, Ng, & Aziz, 2018; Mahboob et al., 2021; Porta, Lopez, Shleifer, & Vishny, 1999) will go a long way in encouraging ethically correct practices. The need for revising essential governance documents (Raelin & Bondy, 2013) and fostering societal concerns should be a key revival initiative. This is especially important given Berghe and Levrau (2004), field findings from practitioners that certain soft boardroom elements are missing in both academic literature and governance rankings. Firms with good Corporate Ethical Identity (CEI) enjoy more stakeholder satisfaction, which positively influences the bottom line (Berrone, Surroca & Tribo, 2007; Ntim & Soobaroyen, 2013). Ethical practices do contribute to the bottom line (Brammer, Brooks & Pavelin, 2009; Ntim & Soobaroyen, 2013; Bozec & Dia, 2015), as well as inducing investment (Wang & Chen, 2017) and as such, should be incorporated into the corporate governance structure (Raelin & Bondy, 2013) of the firm by the board of directors (Bonn & Fisher, 2005). But stakeholders do need to differentiate (Choi, Lee & Park, 2013) between current, and future corporate social responsibility initiatives.

Thus, it can be concluded that the traditional agency theory needs to be revised (Cuevas-Rodriguez, Gomez-Meija & Wiseman, 2012; Raelin & Bondy, 2013), taking into perspective a more behavioral and organizational perspective. Corporate governance should be augmented (Raelin & Bondy, 2013) into good and questionable corporate governance (Mattingly & Berman, 2006) as two different and distinct entities, along with the directors' compensation.

FUTURE STUDIES

Future studies should focus on analyzing the relationship between good and questionable corporate governance practices. Is good corporate governance dominant or recessive in the presence of questionable governance practices? Do the compensation packages of the board of directors influence good and questionable governance? Further, the need to develop a cultural framework of disclosure and transparency that ripples throughout the organization.

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