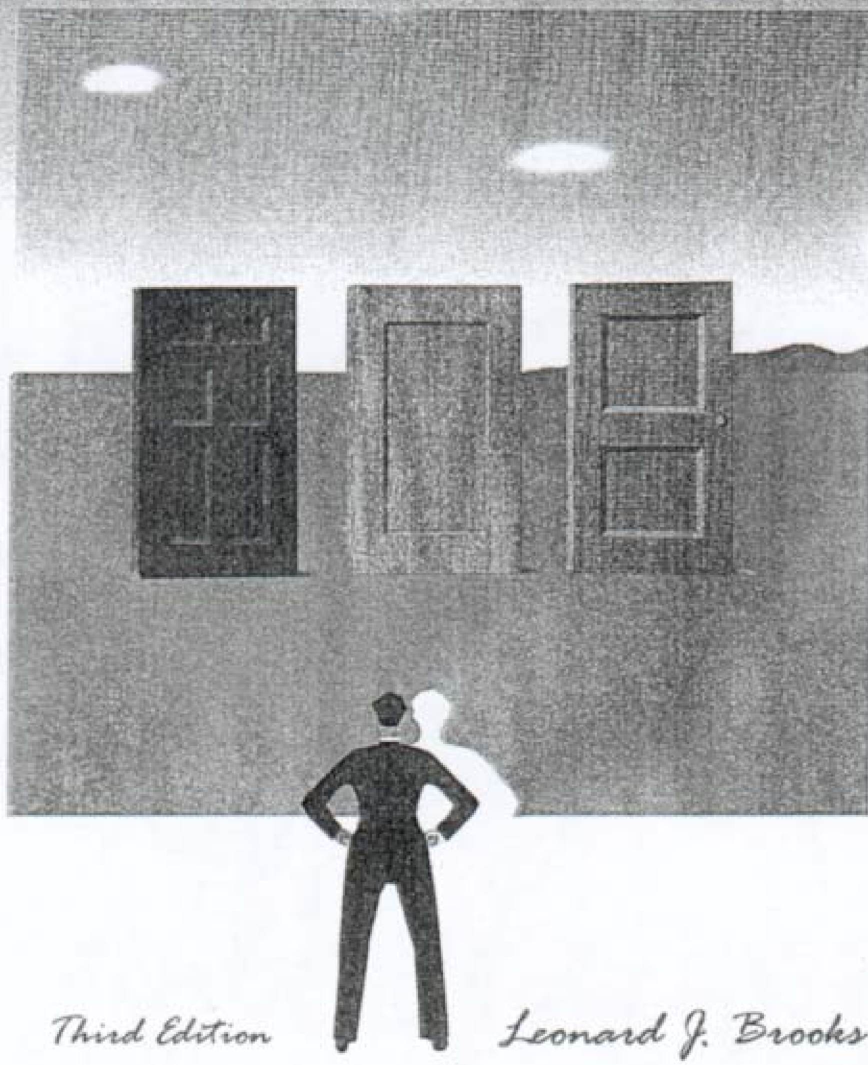

Third Edition

Leonard J. Brooks

Business & Professional Ethics for Directors, Executives, & Accountants

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officer with ongoing responsibility for discovery, assessment, and reporting to the CEO and audit committee of the board, are logical steps to take as well. Reward recognition should be accorded to employees who bring issues forward. Prevention is the most important aspect of crisis management and ethics risks have a nasty way of becoming crises if not diagnosed early enough.

The principles of ethics risk management are summarized in Table 3.3. As the importance of maintaining the support of stakeholders becomes more apparent and widely accepted, ethics risk management will become a normal element of the due diligence requirements for a board of directors and a significant part of management's responsibility.

TABLE 3.3

ETHICS RISK MANAGEMENT PRINCIPLES

Normal definitions of risk are too narrow for Stakeholder-oriented accountability and governance
An *ethics risk* exists where the expectations of a stakeholder may not be met.
Discovery and remediation are essential in order to avoid a crisis or the loss of the support of stakeholders.
Assign responsibility, develop annual processes, board review

CONFLICT OF INTERESTS

Conflict of interests has been a subject of extreme importance in recent scandals where agents and professionals failed to exercise proper judgment on behalf of their principals. In the Enron fiasco, senior officers, lawyers, and professional accountants acted in their own self-interest rather than for the benefit of the shareholders of Enron. The conflict between the self-interest of the decision makers and the interest of the shareholders interfered with the judgment being applied, causing the interests of the shareholders to be subjugated to the self-interest of the decision makers. As a result, Enron declared bankruptcy, investors lost their savings, and capital markets lost credibility and fell into a turmoil. As a result, the governance frameworks for corporations and professional accounting will be changed forever.

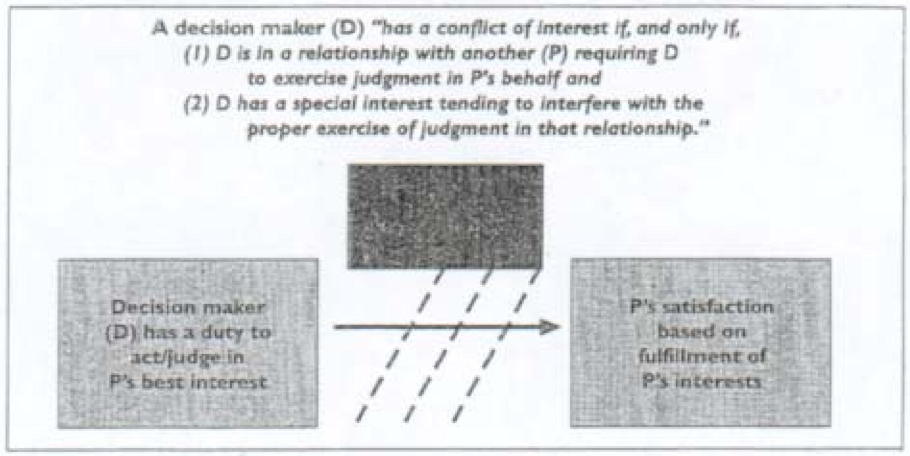
Stated simply, a conflict of interest occurs when the independent judgment of a person is swayed, or might be swayed, from making decisions in the best interest of others who are relying on that judgment. An executive or employee is expected to make judgments in the best interest of the company. A director is legally expected to make judgments in the best interest of the company and its shareholders, and to do so strategically so that no harm and perhaps some benefit will come to other stakeholders and the public interest. A professional accountant is expected to make judgments that are in the public interest.

Decision makers usually have a priority of duties that they are expected to fulfill. A conflict of interest confuses and distracts the decision maker from that priority of duty, resulting in harm when legitimate expectations are not fulfilled. This situation is illustrated in Figure 3.5 where a decision maker (D) "has a conflict of interest if, and only if, (1) D is in a relationship with another (P) requiring D to exercise judgment in P's behalf and (2) D has a special interest tending to interfere with the proper exercise of judgment in that relationship."[6]

[6] *Conflict of Interest in the Professions*, edited by Michael Davis and Andrew Stark, Oxford University Press, 2001. Note that D and P can be a person or a corporate body. Davis uses only P.

FIGURE 3.5

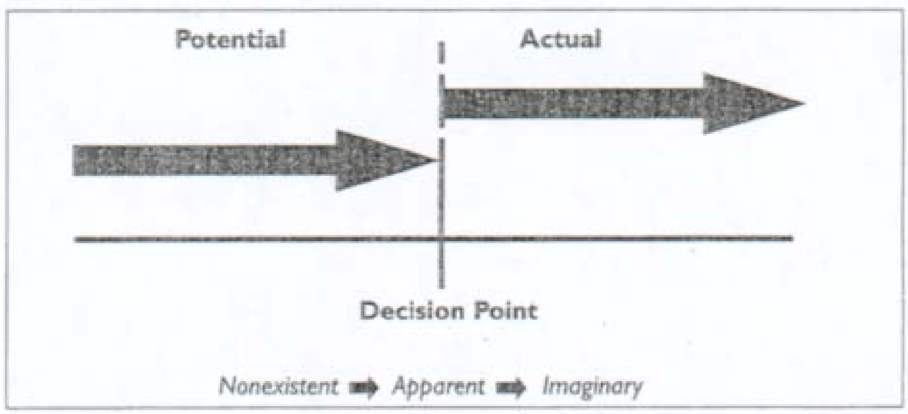
CONFLICT OF INTEREST FOR A DECISION MAKER



A conflict of interest is *potential* if, and only if, D is not yet in a situation where he or she must (or, at least, should) make that judgment. A conflict of interest is *actual* if, and only if, D is in a situation where he or she must (or, at least should) make that judgment.[7] Sometimes the term *apparent* conflict of interest is used, but it is a misnomer because it refers to a situation where no conflict of interest exists, even though due to lack of information someone other than D would be justified in concluding (however tentatively) that D does have one.[8] Figure 3.6 illustrates these concepts.

FIGURE 3.6

TYPES OF CONFLICT OF INTEREST



A special or conflicting interest could include "any interest, loyalty, concern, emotion or other feature of a situation tending to make D's judgment (in that situation) less reliable than it would normally be, without rendering D incompetent. Financial interests and family connections are the most common sources of conflict of interest, but love, prior statements, gratitude, and other subjective tugs on judgment can also be"[9] relevant. Table 3.4 provides a list of causes of conflicting interests.

[7] Ibid. 15.
[8] Ibid. 18.
[9] Ibid. 9.

TABLE 3.4
CAUSES OF CONFLICTING INTERESTS

How might judgment be swayed ...
- Any interest, influence, loyalty, concern, emotion, or other feature tending to make judgment less reliable than normal

Self-interest ...
- Bribes, kickbacks — payments or property to decider, family, designees
- Gifts, free travel, favors
- Special advantages — nonmarket discounts on goods
- Special treatment — flattery, social involvement
- Dealings with family, relatives, or relations

Fraud ...
- Misappropriation of funds or property
- Cheating on expense accounts
- Falsifying documents
- Stealing cash, assets, or resources
- Falsifying results to obtain bonuses, merit pay, or promotion

Misunderstanding ...
- Confused signals or incentives
- Boss/everybody's doing it
- Cultural differences

Slippery Slope ...
- Where a small favor leads to ever larger demands

Concern over a conflict of interest stems from:

- The fact that people who are relying upon D's decision may be harmed if D does not respond or compensate.
- If D knows or should have known, but does not tell P, then D is perpetrating a deception.
- If D's judgment will be less reliable than it ordinarily is.

A conflict of interest is more than just bias, which can be measured for and adjusted. However, due to the unknown nature and therefore extent of the influences, *concern should be for any tendency toward bias.*[10]

Management to Avoid and Minimize Consequences

To remedy the concerns over a conflict of interest, three general approaches should be considered: (1) avoidance, (2) disclosure to those stakeholders relying upon the decision, and (3) management of the conflict of interest so that the benefits of the judgment made outweigh the costs.

Avoidance is the preferred approach if the appearance of having a conflict of interest can be avoided as well the reality. The appearance of having a conflict can often be as harmful to the decision maker's reputation as having a real conflict because it is almost impossible to recover lost credibility and reputation without extreme effort and cost, and then only with luck. Consequently, for example, it is advisable to provide rules against giving or receiving kickbacks since it is difficult to argue later that they really didn't matter.

[10]Ibid. 11, 12.

Management of potential conflicts is a potentially useful approach if avoidance is not possible and the cost-benefit trade-off of management measures is favorable. The probability that reputation will be lost and the related cost must be taken into account in the trade-off analysis. The important aspects related to the management of conflicts of interest are identified in Table 3.5.

TABLE 3.5

MANAGEMENT OF CONFLICTING INTERESTS

Steps To Be Taken

- Ensure awareness through:
  - Codes of conduct and
  - Related initial and ongoing training
- Create a program to provide an understanding of:
  - Employer's concerns regarding conflict of interests
  - Major issues:
    - Avoidance is preferable
    - Slippery slope
    - Management techniques:
      - Annual code sign-off, confirming review and compliance
      - Guidelines for gifts, behavior
      - Counseling, reporting, reinforcement
      - Chinese walls/firewalls; scrutiny

The first step in the process of managing to defend against these influences is to ensure that all employees are *aware* of their existence and consequences. This can be done through codes of conduct and related training. One of the items that should be covered in the training is the slippery slope problem where an individual can be enticed into a relationship by a seemingly innocuous request for a small favor, then a larger one, and then find that they are told that unless they go along with a serious infraction, their past secrets will be revealed. The start of the slope is too gentle for some to notice, but the slope becomes steeper and more slippery very quickly.

The second step is to *create an understanding* of the reasons: why the employer cannot afford unmanaged conflict of interest situations; and why guidelines have been developed to prevent their occurrence, their exploration through counseling if recognized, their reporting if they have occurred, as well as penalties for their occurrence and nonreporting. Annual written confirmations of ethical behavior and adherence to the employer's code of conduct should include reference to conflicts of interest encountered by the signatory, and those identified involving others.

One set of guidelines that can prove helpful are those that specify when it may be acceptable to give or accept a gift or preferential treatment. Useful questions to ask in this regard are shown in Table 3.6. They are intended to assess whether the offering is likely to sway the independent judgment of the professional. Obviously something worth a very modest amount, perhaps under $100, that is offered to a group of people as a publicity venture is much less of a problem than a high-value item offered to one person who has considerable influence over the fortunes of the giver.

Additional reinforcement of problems and good examples through publicity will also serve to keep the awareness and understanding fresh. Compliance

TABLE 3.6

GUIDELINES FOR ACCEPTANCE OF GIFTS OR PREFERENTIAL TREATMENT

1. Is it nominal or substantial?
2. What is the intended purpose?
3. What are the circumstances?
4. What is the position of sensitivity of the recipient?
5. What is the accepted practice?
6. What is the firm/company policy?
7. Is it legal?

systems must be in place to provide another type of reinforcement, with appropriate penalties for significant wrongdoings.

Agency Theory, Ethics and Sears

Directors, executives, and professional accountants should appreciate that incentive systems that they use to motivate employees can provide appropriate or inappropriate reinforcement, depending on the way in which they are designed. In many ways, the stock option plans available to executives in the Enron, WorldCom, Waste Management, and Sunbeam cases were responsible for motivating them to the detriment of all stakeholders involved.

According to agency theorists, shareholders expect and hope managers, and in turn nonmanagerial employees, will behave in line with the goals set for the corporation. In their terms, the principals or shareholders hope that their agents will be motivated to act as the principals wish. Incentive systems and punishment systems are created to try to influence the agents to stay on the right path. Clearly, as the public's expectations for corporate performance now include ethical standards, the reward and punishment systems set up should also reflect ethical dimensions or shareholders will be disappointed. In fact, the corporation's strategic plans should include ethical dimensions to ensure that their agents, both inside and outside the corporation, are properly influenced and conflicts of interest are avoided. One recent case in point involves the incentive system put in place by Sears for the managers of their auto service stores. The managers' remuneration depended upon the volume of sales made by the store, but this led to the selling of services that customers didn't need to boost the managers' earnings. A national scandal erupted, and Sears apologized for creating a misleading incentive system.

Chinese Walls/Firewalls

An important system for preventing ethical malfeasance, the "Chinese wall" or "firewall" concept, deserves further comment. This practice uses the analogy of an impervious wall to describe those measures and methods that would prevent the transmission of client information from one part of an organization to another. Such firewalls or Chinese walls are not tangible in a three-dimensional sense, but refer to a multidimensional set of measures such as:

- Instructions to keep information confidential
- Instructions not to read, listen to, or act on specific types of information
- Educational programs and reinforcements by top management
- Monitoring and compliance sign-off procedures

- Scrutiny of insider or key-person trading of securities
- Physical barriers to information transmission, such as:
  - Separate computer- or physical-storage systems
  - Segregation of duties to different employees
  - Segregation of information in a different location or building, etc.
  - Different lock systems
- Appointment of a compliance officer who will monitor the effectiveness of the wall
- Disciplinary sanctions for breach of the wall

Chinese walls or firewalls have been a normal part of business and professional operations for many years. For example, when a client is involved in the preparation of a public offering of securities, those members of the offering team (lawyers, professional accountants, and underwriters) are expected not to divulge advance details of the underwriting to the other members of their respective firms, or to anyone else. The public issuance of securities, as presently known, would be impossible without the Chinese wall construct. Fortunately, even though in the final analysis a Chinese wall relies upon the integrity of the employees involved for its effectiveness, such arrangements are considered effective to protect the public interest and to safeguard the interest of current clients as well as former clients.

Forensic Experts and Evidence: The 20/60/20 Rule

The time may come when a director, executive, or professional accountant must consider whether a conflict of interest has led to serious breach of duty, a fraudulent act, or a matter that must be recovered pursuant to an insurance policy. In such instances, an investigative and forensic expert may be called upon if existing company employees would benefit from assistance. The expert will employ appropriate techniques based upon their understanding of the situation.

Many managers may believe that their associates and employees would rarely engage in unethical behavior. However, forensic experts indicate that their experience suggests that the general population can be divided into three groups:

- 20 percent would never commit a fraud.
- 60 percent would seek to commit a fraud depending on the circumstances.
- 20 percent would seek to commit a fraud.

The important questions, then, are who would commit a fraud and what are the circumstances that could come into play in the decision.

The GONE Theory: Identifying Potentially Harmful Situations and Likely Perpetrators

Forensic experts point out that in most instances of fraud or opportunistic behavior, they can begin to identify prospective perpetrators through the use of the GONE Theory. The acronym, GONE, stands for circumstances that account for motivation of illicit behavior, where:

- G – Greed
- O – Opportunity to take advantage
- N – Need for whatever is taken
- E – Expectation of being caught is low

The experts point out that identifying employees who have or exhibit these characteristics can head off problems if adequate precautions are taken. These would include additional review and diligence on the part of supervisors, transfer to less vulnerable areas, signaling that extra review or audit procedures were in place, etc. For example, if an employee exhibited signs of a lifestyle well beyond his or her means, then extra scrutiny might be warranted.

Duty Depends Upon a Person's Role

While this analysis of conflict of interests has focused on the individual, it should be noted that the elements are similar for groups of individuals within a corporation, organization, or profession. But either as individuals or groups of individuals, it is often the roles taken on, and therefore the duties assumed based upon the expectations of those relying on the actions to be taken, that define the nature of conflicts of interest. For example, it is unlikely that a professional accountant auditing or judging financial statements can audit objectively her or his own work without bias, or maintain objectivity if asked to assume an advocacy role by a client. In order to ensure sufficient objectivity to maintain their duty to serve the public interest, professional accountants have developed standards designed to ensure independence.[11] These will be discussed later in the next chapter.

Corporate Governance and Accountability

DEVELOPING, IMPLEMENTING, AND MANAGING AN ETHICS CULTURE

Directors, owners, and senior management are realizing that they and their employees need to understand that (1) their organizations would be wise to consider the interests of stakeholders, not just shareholders; and that (2) appropriate ethical values are to be considered when decisions are being made. *Because organizational, professional, and personal values provide the framework to decision making, it is vital that organizations create an environment or culture where appropriate values are created, understood, fostered, committed to and used by all concerned.* This cannot be reliably achieved by simply leaving ethics solely to the judgment of individuals in a workforce of divergent experiences and backgrounds to work out by trial and error. Nor can it be achieved simply by sending a letter urging employees to be on their best behavior, or by just publishing a code of conduct. In order to ensure commitment to the ethical principles or values considered appropriate for the organization, it must be evident to the members of the organization that top management is fully supportive

[11]See for example the International Federation of Accountants (IFAC) Code of Ethics for Professional Accountants, November 2001, (see *http://brooks.swlearning.com*).

and that such support is evident throughout the organization's governance systems.

A most important aspect of an ethics program designed to ensure an effective understanding and commitment to the organization's ethical principles is the choice of program orientation. According to researchers, there are five orientations for the design and operation of ethics programs. These are described in Table 3.7.

TABLE 3.7

ETHICS PROGRAM ORIENTATION TYPES

ORIENTATION	PRIMARY FOCUS
Compliance-based	Preventing, detecting, and punishing violations of the law
Integrity or values-based	Defines organizational values and encourages employee commitment
Satisfaction of external stakeholders	Improvement of image and relationships with external stakeholders (customers, the community, suppliers)
Protect top management from blame	"CYA" or cover your ___
Combinations of the above	Values- and compliance-based, for example

SOURCES: Treviño, Weaver, Gibson, and Toffler, 1999, 135–139; Paine, 1994, 111; Badaracco & Webb, 1995, 15.

The researchers went on to evaluate the effectiveness of the impact of these orientations by administering over 10,000 surveys to randomly selected employees in six large American companies from a variety of industries. The dimensions upon which the impact was evaluated were:

1. Unethical/illegal behavior
2. Employee awareness of ethical issues that arise at work
3. Looking for ethics/compliance advice within the company
4. Delivering bad news to management
5. Ethics/compliance violations are reported in the organization
6. Better decision making in the company because of the ethics/compliance program
7. Employee commitment to the organization

According to their research, which confirms the author's experience gained when consulting organizations on the design of their ethics programs, *the most important factor in encouraging employee observance is that the employees perceive that the ethics program is values-based.* This produced significantly more positive outcomes on all seven dimensions. Compliance and external orientations also produced favorable outcomes on the seven dimensions, but not as positive as for the values-based approach. The external orientation outcomes were less than the compliance-based approach. CYA was considered a "harmful" approach, as it resulted in negative outcomes across all dimensions. It was suggested that combined approaches could be effective, such as if a values orientation were "backed up with accountability systems and discipline for violators" where "values can include concern for customers, suppliers, and the community as well as shareholders and internal stakeholders such as employees" (Treviño et al., 1999, 139).

The study also provides some useful insights into the important aspects of an ethical culture. These are included in Table 3.8.

TABLE 3.8

ETHICAL CULTURE: IMPORTANT ASPECTS

An ethical culture combines formal and informal elements to guide employee thought and action, including

- Ethical leadership by executives and supervisors*
- Reward systems to incorporate ethical considerations*
- Perceived fairness, fair treatment of employees*
- Open discussion of ethics in the organization*
- Authority structure that emphasizes an employee's accountability and responsibility to question his or her own actions, and an obligation to question authority when something seems wrong*
- Organizational focus that communicates care for employees and the community, rather than self-interest
- Official policies and procedures (code of ethics, practice, conduct)
- Supporting offices (e.g., ethics officer, ombudsperson)
- Supporting structures (e.g., telephone hotline, whistle-blower protection, code sign-off, training, etc.)

* Most influential factors as found by Treviño et al.

The findings presented in Table 3.8 can be particularly useful for a company that is assessing what it might do to institute a new ethics program or improve its current ethical culture. It would appear that there is quite a lot that could still be accomplished in the development of ethical cultures based upon the status of indicators shown in Table 3.9 recommended for a healthy corporate culture. Table 3.9 has been prepared from U.S. *Fortune 1000* data published in a study by Weaver, Treviño, and Cochran (1999a) and from Canadian large-firm data published as part of the *1999 KPMG Business Ethics Survey: Managing for Ethical Practice,* which is available in full on the KPMG website.

http://brooks.swlearning.com

The figures in Table 3.9 show that while most companies have embraced the concept of written ethical guidance, they have fallen far short of embracing many of the supportive mechanisms that are important to the development and maintenance of a healthy ethical culture. Among the omissions of most concern are lack of CEO involvement, lack of training, failure to renew employee commitment to the code annually, and the lack of communications and meetings dealing with ethics. From other sources, we find concerns raised about lack of formal program follow-through; inappropriate placement of the ethics function within the legal department, which focuses on compliance rather than on employee and other stakeholder welfare; employing "quick fix" approaches rather than building a long-term solution; training by people who don't have a commitment to live with the result—top management should be more prominent; and telephone answering by distant outsiders who callers have difficulty believing that the company cares and is taking their calls seriously (Treviño et al., 1999).

TABLE 3.9

ETHICS PROGRAM ELEMENTS EMPLOYED IN NORTH AMERICA

RESPONSE RATE	U.S. USAGE % IN 1995 25.7% OF 990	CANADIAN USAGE % IN 1998 16.6% OF 1225
Formal Documents	98	85
Codes/mission statements	78	68
Values and principles		83
Guidelines		48
Policy manuals	67	45
Other (speeches, letters, memos, etc.)	22	30
Ethics Policy: Dissemination to 80 percent of		
High-level executives	100	
Middle managers and professionals	98	
Lower-level management/superv. staff	87	
Nonsupervisory staff	75	
Internally/externally		93/36
Acknowledgement of Receipt/Obedience		
At least once in an employee's career	90/85	60
Annually	45/51	
Ethics Personnel and Officers		
Report to: CEO/exec. vice president	18/54	
Single officer assigned responsibility	54	40
Within: Legal dept.	33	
Ethics/compliance	32	
Audit	10	
Human resources	9	
General admin.	10	
Specific ethics office or dept.	30	
Ethics office staff: at most 1 staff	55	
Support system, incl. hotline		47
Whistle-blower Protection (up from 22 percent in 1997)		38
External Assessment of Ethical Performance	50 approx.	
Assessment of Program: yes/one year/external		32/41/32
Standard Procedures for Dealing with Problems	70	
Telephone Reporting	51	
Internal department answers	34	
Called . . . hotline/. . . helpline (value-oriented)	57/19	
CEO Involvement		
Communications per year 0/1-2/2+	20/46/34	
Meetings per year 0/1/2+	32/30/38	
Communications—once per Year or Less	75 approx.	
Training (approx.)		27
Never/at hiring/every few years/annually	28/12/38/19	

In addition, when the current evidence about the scope and orientation of ethics programs is compared to what they could be as control systems, they were found to be suboptimal. According to a study by Weaver, Treviño, and Cochran (1999b), formal ethics programs usually include the dimensions listed in Table 3.10.

TABLE 3.10

ETHICS PROGRAMS' USUAL DIMENSIONS

1. Formal ethics codes
2. Ethics committees developing policies, evaluating actions, investigating and adjudicating policy violations
3. Ethics communications systems
4. Ethics officers or ombudspersons coordinating policies, providing education, or investigating allegations
5. Ethics training programs to raise awareness and help employees respond to ethical problems
6. Disciplinary processes for unethical behavior

Weaver et al. reuse the surveys received in their previously reported study to examine the motivation of top management for their commitment to ethics and how this affects the scope and orientation of ethics programs of the *Fortune 500* companies. They argue that the degree to which a values or a compliance orientation characterizes an ethics program's mode of control can be seen in the program's emphases on encouraging shared values, supporting employee aspirations, communicating values, and building trust and confidence. They conclude that the dominant influence of the U.S. Sentencing Guidelines has been to orient top management commitment and corporate ethics programs toward compliance rather than integrity or values. This orientation—according to the earlier Treviño et al. study—will not provide the best adherence to desired ethics values. Hopefully, over time, top management will learn that a values orientation that involves encouraging shared values, supporting employee aspirations, communicating values, and building trust and confidence will produce significant benefits, and ethics programs will move in that direction.

It is worth noting that current research suggests that the values-oriented ethics program can have benefits other than those previously described. In particular, building trust within an organization can have favorable impacts on employees' willingness to share information and ideas, thereby enhancing the innovation quotient of the enterprise and its ability to adapt and take advantage of its opportunities. This process is called *ethical renewal*. Properly cultivated trust can also create commitment to organizational goals and enhance productivity, all of which will raise the ability of the enterprise to profit and compete. This can all be fostered with appropriate attention in the design of the code of conduct (Brooks, 2000). Others are also working on trust as is evidenced by entire special volumes of journals such as *Business Ethics Quarterly*, Vol. 8, No. 2, April 1998; and *Academy of Management Review*, Vol. 23, Issue 3, July 1998.

The discussion to this point has provided an understanding of why organizations—be they corporations, not-for-profit organizations, or professional firms—should develop an ethical culture, what shape that culture should take, and why. Table 3.11 puts these ideas together in an orderly sequence, with additional ideas found in later chapters that a manager, ethics officer, or professional accountant can use to develop and maintain an ethical corporate culture. Information obtained from the Ethics Officer Association and the Center for Business Ethics at Bentley College would be helpful in keeping abreast of current developments.

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The design and introduction of the type of system proposed is well within the capacity of professional accountants because of their exposure to the nature, purpose, and workings of internal control systems. It is not surprising that several large professional accounting firms have developed services such as the KMPG Ethics & Integrity Practice, which "focuses on managing for ethical practice—establishing effective compliance and control, developing ethical awareness within the workforce, and addressing ethical risk through a managed ethics process" (KPMG, Ethics & Integrity website, 1999). Four specific services are mentioned:

- Business Ethics Process Review (an ethics audit)
- Implementation and Integration of Ethics Process Initiatives
- Ethics and Integrity for Boards of Directors
- Ethics and Integrity Awareness and Training

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Similar practices are offered by most of the large professional accounting firms. (See the text's website.)

CORPORATE CODES OF CONDUCT

Purpose, Focus, and Orientation

According to The Conference Board,

> The foundation of most corporate ethics programs is the company code or business conduct statement. Company business ethics principles statements stress two objectives: (1) improving employee capability for making decisions that are in accord with policy and legal requirements; and (2) giving concrete expression to the company's sense of mission and its view of the duties and responsibilities that corporate citizenship entails[12]

An effective code is the embodiment of an organization's values. It represents the major organizational structure in which to implement ethical policy (see Murphy, 1988, attached as a reading) and to signal and communicate behavioral expectations and culture, as well as to provide strategic and legal positioning for the organization. It is an essential part of a modern system of internal control. Unless employees are told, in writing, how they are expected to behave, managers, executives, and directors are vulnerable to charges that they failed to provide adequate guidance to their workers. If so, the company and its officers and directors can be fined heavily, and in some jurisdictions the officers and directors can go to jail. More importantly, it has been suggested that the fines and court costs involved in ethical dilemmas are usually smaller than the lost future profit margin due to the disenchantment of customers. Whistle-blowing outside the corporation may also be prevented by effective

[12] *Global Corporate Ethics Practices: A Developing Consensus*, The Conference Board, New York, 1999, 16.

TABLE 3.11

DEVELOPMENT AND MAINTENANCE OF AN ETHICAL CORPORATE CULTURE

STEP	PURPOSE
Assign responsibility: Chairman or CEO Ethics officer Ethics committee	Successful initiatives usually involve: ▪ top level accountability and adequate budget ▪ champions, arbiters ▪ monitoring, feedback, advice, and cheerleading
Ethics Audit	To understand the organization's ethical practices and its network of stakeholders and interests
Ethics risk assessment	To identify important ethics problems that could arise (see Chapter 6)
Top management support	Absolutely vital to successful adherence
Develop consensus on key ethical values	Necessary to frame policies and procedures
Develop code of conduct, ethical decision-making criteria and protocols, incl. sniff tests	Provide guidance for employees and all other stakeholders
Develop ethics program: Leaders involvement Launch Training Reinforcement policies: Compliance sign-off Measurements of performance Include in strategic objectives and managers' objectives Include in monitoring and reward structures Communications programs Exemplar award system	To successfully present and provide supporting mechanisms for the guidance process
Ethics inquiry service	Information, investigation and whistle-blower protection
Crisis management	To ensure that ethics are part of survival reactions
Establish a review mechanism	

ethical codes because they can help to create an ethical culture in which employees believe doing what is right is expected and bringing forward concerns over unethical behavior will not result in ethical martyrdom.

Codes can be drafted to fulfill different rationales and to provide different depths of coverage. Table 3.12 describes four common levels of coverage.

TABLE 3.12

DEPTHS OF CODE COVERAGE

Credo	Inspirational short statement on key values
Code of Ethics	Deals with ethics principles (short)
Code of Conduct	Deals with principles plus additional examples, etc.
Code of Practice	Detailed rules of practice

The rationales[13] for developing codes that were identified by The Conference Board in its 1999 survey of global ethics practices included:

1. *Instrumental* — to make employees aware that "employee adherence to the company's ethical principles is critical to bottom-line success"
2. *Compliance* — to provide a "statement of do's and don'ts to govern employee conduct"
3. *Stakeholder Commitment* — to offer a discussion of what is expected behavior in stakeholder relationships
4. *Values/Mission* — to establish "certain ethics principles, modes of behavior, and habits of mind as essential to what is means to be an employee or representative of the company" (see Johnson & Johnson credo in the reading by Murphy)
5. *None or a composite* of the above

The Conference Board found that the use of these rationales varied depending on the country or region involved. In the United States, the dominant "instrumental" choice reflects the pressures from stakeholders and the legalistic environment faced in which potentially heavy sanctions have been created for misdeeds due to the advent of the U.S. Foreign Corrupt Practices Act and the U.S. Sentencing Guidelines. Elsewhere, except in Latin America, the values/mission approach was most popular. The choices of rationale, by region, are noted in Table 3.13.

The research findings of Weaver et al. (1999b), Treviño et al. (1999), and others noted earlier in the chapter indicate that a corporate code with an integrity or values orientation will be more effective in engendering adherence to desired ethical standards than other alternatives. Most successful will be a code that is a combination in which the focus is on the important values that the corporation wants to apply in its stakeholder relationships, reinforced by sanctions inherent in the compliance approach. Such a composite orientation code would encourage shared values, support employee aspirations, communicate values, and build trust and confidence, while indicating that processes were in place to monitor and judge ethical performance. The composite orientation

[13]Ibid., 24–27.

TABLE 3.13

DOMINANT RATIONALES FOR CODES BY REGION[14]

	UNITED STATES	CANADA	EUROPE	LATIN AMERICA	JAPAN
Instrumental	64%	30%	-	50%	17%
Stakeholder	5	10	30	-	17
Legal Compliance	14	-	-	25	33
Values/Mission	14	40	60	25	33
None	2	20	10	-	-
N = 72					

code would also provide motivation to employees in all six stages of Kohlberg's model of moral reasoning (see Table 4.3).

The form and nature in which guidance is given and action expected can also limit or foster optimal motivation for moral reasoning. Four alternatives are possible for the nature of the guidance provided. The alternative chosen will provide a signal to employees about the way the organization thinks about its control structure, ranging from an autocratic, imposed control structure on one end of the spectrum to self-imposed control on the other. Table 3.14 identifies the four alternatives and the nature of control they signal.

TABLE 3.14

CODE GUIDANCE ALTERNATIVES AND THE CONTROL/MOTIVATION SIGNALED

GUIDANCE PROVIDED	CONTROL/MOTIVATION SIGNALED
Obey these rules	Imposed Control
Seek advice before acting	↑
Act on your best judgment, but disclose what you have done	
Guiding principles that indicate "this is what we are and what we stand for"	↓ Self-control

SOURCES: Clarkson & Deck, 1992, Clarkson, Deck & Leblanc, 1997.

In view of the findings of Maslow (1954) and McGregor (1960), and subsequently others who argued that an autocratic management style was less effective than a democratic or participative approach, it is likely that using only imposed control techniques could be similarly suboptimal. Maslow argued that autocratic

[14]Ibid., 28.

management techniques involved influence attempts directed at the lower level of his hierarchy of human needs (physiological, safety), whereas a democratic or participative approach was directed at higher-level needs (affiliation, esteem, and self-actualization) and therefore was more likely to provide a sustainable and more engaging level of motivation. In a world that has since moved toward employee empowerment rather than imposed control (Simons, 1995), a code that employs only imposed control is likely to be less effective than one that encourages self-control. A code that successfully encourages self-control would appeal to individuals in all of Kohlberg's six stages of moral reasoning, whereas the imposed control code would motivate only for the lower four stages. In keeping with the reasoning in favor of a composite-oriented, values-based, and compliance-based code, consulting experience has shown that the most successful codes encourage self-control or empowerment, with absolute rules being introduced where necessary. These codes usually provide a set of principles with explanations or rationales being given for each. These principles and their rationales are to be used by employees to reason how to deal with the decisions they face, or to determine whom to contact if they need counsel.

Code Content and Scope

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Numerous readings are available that outline the topics that are covered in different codes, such as these by Clarkson & Deck (1992), White & Montgomery (1980), Mathews (1987), Berenbeim (1987), and Brooks (1989). Examples of different codes are available on the websites of major corporations.

The choice of orientation of the code and its topics depends somewhat on the scope of the code. Is the code intended to provide guidance to the company's own employees, its suppliers and vendors, and/or its joint venture partners? Geographic locale, union contracts, legal restrictions, competitive practices, and the degree of ownership and/or partner support inherent in the scope decision are critical to the orientation and choice of topics to be included. If a company cannot be comfortable about the guidance to be given, then it should consider whether the arrangement is too high a risk to be undertaken. For example, to do business with a partner or in a repressive regime that does not respect human rights, should give rise to consideration of non-involvement.

In the late 1990s, Nike's suppliers used sweatshop and child labor to produce low-cost products, but this triggered boycotts and necessitated the development of monitoring and reporting mechanisms. Recently, stakeholder activists have become much more aggressive in making companies accountable for the actions of suppliers and joint ventures. Three organizations are leading the development of supplier/workplace standards and codes of conduct: Social Accountability International (SAI) and Fair Labor Association (FLA), Maquila Solidarity, and the International Labor Office (ILO). SAI has developed the SA 8000, which is a standard designed to improve working conditions globally, and it is engaged in the training of auditors for the certification of companies adhering to SA 8000. It is modeled after the ISO standards.

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Table 3.15 presents a representative list of topics a company might consider including in its codes for its employees, suppliers, and joint ventures.

TABLE 3.15

SUBJECTS FOUND IN CODES

Ethical principles—honesty, fairness, compassion, integrity, predictability, responsibility

Respect for stakeholder rights, and duties owed to each stakeholder

Vision, mission, and key policies tied into the above

Ethical decision-making frameworks, sniff tests, rules of thumb, and guidance on making trade-offs between competing objectives

When to seek counsel, and whom to seek it from

Specific topics found in over 5 percent of employee, supplier, and joint venture codes:

- Bribery/improper payments or influences
- Conflict of interest
- Security of proprietary information
- Receiving gifts
- Discrimination/equal opportunity
- Giving gifts
- Environmental protection
- Sexual harassment
- Antitrust
- Workplace safety
- Political activities
- Community relations
- Confidentiality of personal information
- Human rights
- Employee privacy
- Whistle-blowing and protection programs
- Substance abuse
- Nepotism
- Child labor

SOURCE: The Conference Board Research Report, *Global Corporate Ethics Practices*, 1999, 29.

Each company should undertake a review of its code when issues and risks emerge that require adjustment of the coverage. For example, codes have been modified in reaction to the external shocks identified in Table 3.16.

TABLE 3.16

EXTERNAL SHOCKS AND INFLUENCES TRIGGERING CODE MODIFICATION

Antibribery legislation—U.S. Foreign Corrupt Practices Act of 1977
- This act provided an early motivation for codes

U.S. Sentencing Guidelines of 1991
- Brought provision for "due diligence" defense

Environmental responsibility:
- Acid rain, air pollution, ozone depletion
  - (U.N. Brundtland Commission Report of 1987)
- New environmental protection statutes
- Exxon Valdez oil tanker spill triggers Valdez (now CERES) Principles

Fair treatment for:
- Employees:
  - Feminism: sexual harassment, equal opportunity for pay and promotion
  - Minorities: discrimination*
  - Health, safety, and well-being
    - Supplier employees—no sweat shop or child labor
  - Drug problems—privacy vs. safety
  - Whistle-blowers**
- Customers—buyer beware slowly becomes seller beware:
  - Health & safety concerns—auto recalls (see Ford/Firestone case)
  - Ethical consumerism, quality
- Shareholders:
  - Misuse of inside information
  - Conflict of interests
  - Mandate and operations are ethical—Enron's banks engage in transactions without economic substance, designed to mislead

* See Texaco's Jelly Bean case in Chapter 6.

** See GE case described in reading by Andrew Singer in Chapter 1.

Looking ahead, it is likely that codes will be modified to encompass the following:

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- New antibribery statutes enacted in early 1999 by about thirty countries in the OECD who have responded to the call of Transparency International for standards that will outlaw bribery of foreign officials and allow cross-border investigation and litigation by competitors (see the text's website).
- Adherence to company principles by suppliers, particularly in foreign operations with respect to child labor, fair wages, no forced labor, etc.
- Integrity or values orientation
- Self-control instead of only imposed control

According to page 6 of the 1999 KPMG Business Ethics Survey (see the text's website), over 50 percent of Canadian respondents indicated the following to be issues of greater concern over the next three to five years, so their treatment in codes is likely to be modified during that period:

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- Security of information
- Environmental management and performance
- Governance principles—clarification of accountability to the board of directors and stakeholders, transparency, risk management for regular and ethics risks
- Ethicality of objectives and competitive practices
- Sexual harassment

These modifications will also be guided by the application of measures of the effectiveness of codes. Codes can be scored or reviewed for comprehensiveness of coverage and for the nature of control signaled. Other measures have been identified, such as surveys of employee awareness and understanding of key aspects covered in the code and in training programs, as well as their ability to apply these to ethical dilemmas proposed.

Benchmarking of codes is done by many consultants. Company employees can also do so by comparing their code against the subjects that information services report upon or that are included in the Global Reporting Initiative (GRI).

Helpful advice on the preparation of codes can be obtained from several organizations including the following:

- Institute of Business Ethics (IBE)
- Centre for Applied Ethics, University of British Columbia

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Effective Implementation

Because a code of conduct is critical to organizational success, it is important to ensure that a code is both effectively drafted *and implemented.* A properly functioning code is essential to:

- The development and maintenance of an ethical corporate culture
- An effective internal control system
- A "due diligence defense" for directors and officers
- Effectively empower employees to make ethical decisions
- Send proper signals to external stakeholders

In order to avoid implementation problems, the following issues should be kept in mind. First, *top management must endorse and support the code* and be seen to act in accord with it, or it will only be given lip service by management and workers. It is critical that management "walk the talk" or the entire program will be a waste of time and money.

The orientation, tone, and content of the code must be such that *general principles are favored instead of only specific rules,* or else employees will find the code oppressive and hard to interpret, and *background reasons must be given* to permit understanding sufficient for useful interpretation when specifics are not available. Experience has shown that codes designed as extensive rulebooks are rarely useful because they are too difficult to consult. If the underlying reason for a specific pattern of behavior is given, employees find it easier to understand and they buy-in, rather than fight the code or dismiss it. Getting the buy-in is essential.

Guidance should be provided for trade-offs between short-term profit and social objectives. If employees believe profit is to be earned at all costs, then unethical behavior based on short-term thinking can get the company into trouble.

A complete "due diligence" defense should be in place for environmental matters, including the items noted in Table 3.17.

TABLE 3.17

ESSENTIAL FEATURES TO DEMONSTRATE A DUE DILIGENCE DEFENSE IN RESPECT TO ENVIRONMENTAL MATTERS

1. A written environmental policy, made known to appropriate employees
2. Operating practices that guard against environmental malfeasance, including contingency plans to cover mishaps to ensure full-scale, timely cleanup
3. Employees briefed on their duties and responsibilities under the policy, as well as their potential personal liability and the liability of others
4. Employees informed of legal requirements, including notice to government, complete with a contact list
5. A person who is primarily responsible for environmental matters and monitoring compliance
6. Consideration of an environmental audit or consultation with an expert to start the protection process and monitor progress
7. Monitoring of pollution control systems and reporting of mishaps on a timely basis
8. Regular review of reports on compliance, potential problems, environmental charges, conviction, and employee training
9. Management that keeps abreast of new legislation, makes an internal review of compliance and advises directors of the results, and allocates a real and satisfactory budget to achieve these features

Employees should be empowered to make ethical decisions. This should involve setting up *decision protocols* that will require employees to use and be able to defend their decisions against a set of criteria or questions that are outlined further in Chapter 4. Part of the decision process should involve the use of *sniff tests*—quick, simple questions that will alert the decision maker when to undertake an in-depth ethical analysis or to seek counsel. When in doubt over the proper conduct, *employees should be encouraged to seek counsel.* Rather than have them act inappropriately, or waste time needlessly, a company should encourage employees to consult their superior, use a hotline, or consult an ethics officer.

A *fair and confidential hearing process should be assured* or whistle-blowers will not come forward. They don't want to risk paying the price for snitching, even though it is in the best interests of the company. Nor do they want a person accused to be dealt with in a cavalier way—they want a speedy, fair hearing process with protection for both parties. *Whistle-blowing should be legitimized,* and whistle-blowers that come forward should be protected.

Someone should be charged with the *ongoing responsibility for updating the code* so that issues can be referred as they come up. Otherwise, many issues will be lost in the pressures of day-to-day activity or because people won't know where to send their suggestions.

The Code should be distributed to all employees so that none will be able to claim they were not told how to behave. It is surprising that many companies believe their line workers don't have responsibility for environmental acts, for actions toward fellow workers, etc. Not only do excellent suggestions come from the plant, but bad actions are noticed, and support for the company's general activities is enhanced by including these employees.

Training in support of the code is essential. Training should focus on awareness of issues, interpretation of the code in accord with top management wishes, approaches to ethical analysis to enable decisions beyond the code, realistic cases for discussion, and legitimizing the discussion of ethical issues and of whistle-blowing. Codes are written by committees who spend long hours over each paragraph, so how is each employee supposed to know all the thought that went into its construction just by quickly reading the passage? Training is essential to help understand what is meant, and how the code applies to new problems.

Reinforcement of and compliance with the code should be furthered by mechanisms of encouragement, monitoring, and facilitation of the reporting of wrongdoing. These issues should not be left to chance, otherwise the organization might miss an opportunity to head off a disaster or to accomplish an ethical performance objective. These methods are summarized in Table 3.18.

TABLE 3.18

MECHANISMS FOR COMPLIANCE ENCOURAGEMENT MONITORING, AND REPORTING WRONGDOING

Compliance encouragement
Awards, bonuses
Inclusion in performance reviews, remuneration decisions, and promotion
Reprimands, suspension, demotion, fines, dismissal
Monitoring
Ethics audit or internal audit procedures
Reviews by legal department
Annual sign-off by all or some employees
Employee surveys
Facilitation of reporting of wrongdoing
Assurance of a fair hearing process
Protection: absolute confidentiality, whistle-blower protection plan
Counseling/information: ombudsperson program, hotline, human resources
Committee oversight assured: ethics committee of board, audit committee

Reinforcement of the code should be undertaken through measurement of the code's effectiveness; reporting of ethical performance for management purposes; featuring ethical performance in company publications; and ensuring that other company policies are supportive, including a linkage with the remuneration systems. If you can't measure performance (techniques are discussed in Chapters 4 and 5), it is very hard to manage it. Reporting performance has the impact of producing a scorecard that people are induced to improve for the next report. Publicizing good results can have a salutary effect on subsequent performance as well, and including that performance in the corporation's reward systems will go a long way to underscore how important ethical issues are to top management.

To have an effective corporate culture, not only do codes need constant upgrading under the watchful eye of an ethics officer, but constant attention must also be given to improving training programs, measures and reports of performance, and compliance and whistle-blowing mechanisms. In addition, it is essential to have a formal external or internal review of the corporation's culture, code, and other mechanisms on a periodic basis. This is often referred to as an ethics audit. Although it may be undertaken by the internal audit staff or a team of budding managers, such as in the Dow Corning case at the end of the chapter, an outside consulting service can provide useful feedback.

Finally, it should be understood that it is unlikely that employees will see the merit of ethical behavior in regard to one area of the company's operations if they believe management wants or is prepared to tolerate questionable behavior in other areas. Whistle-blowers will not come forward, for example, unless there is a feeling of trust that they and the parties they accuse will be dealt with fairly and confidentially. Consequently, the development of a broadly based ethical culture within the company is an essential precursor for an effective code of conduct, and vice versa.

PUBLIC ACCOUNTABILITY BENCHMARKS

One of the recent developments that a board of directors needs to consider when developing the values, policies, and principles that undergird their corporation's culture and the actions of their employees is the recent surge in scrutiny and public accountability. Never before has there been such interest in what a corporation is doing, and how it is doing it.

In the United States, Canada, and the United Kingdom rating services exist that examine and score corporate governance systems and performance against competitors and external benchmarks. New visibility is being given U.S., U.K., and Canadian companies through social rating services linked to the London Stock Exchange FTSE4Good service. New standards for social performance and disclosure are emerging that will provide comparisons that corporations will watch and build into their mechanisms, performance assessments, and public disclosures. It is doubtful that corporations will be regarded as responsible corporate citizens if their operations are seen not to compare well based on these new comparators. Therefore, at the very least, corporations should maintain a watching brief over developments identified in Table 3.19.

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Conclusion

In an era of increasing scrutiny, where stakeholders without legal claim can influence the achievement of corporate objectives profoundly, it is very much in the interest of shareholders, directors, and executives that their company's