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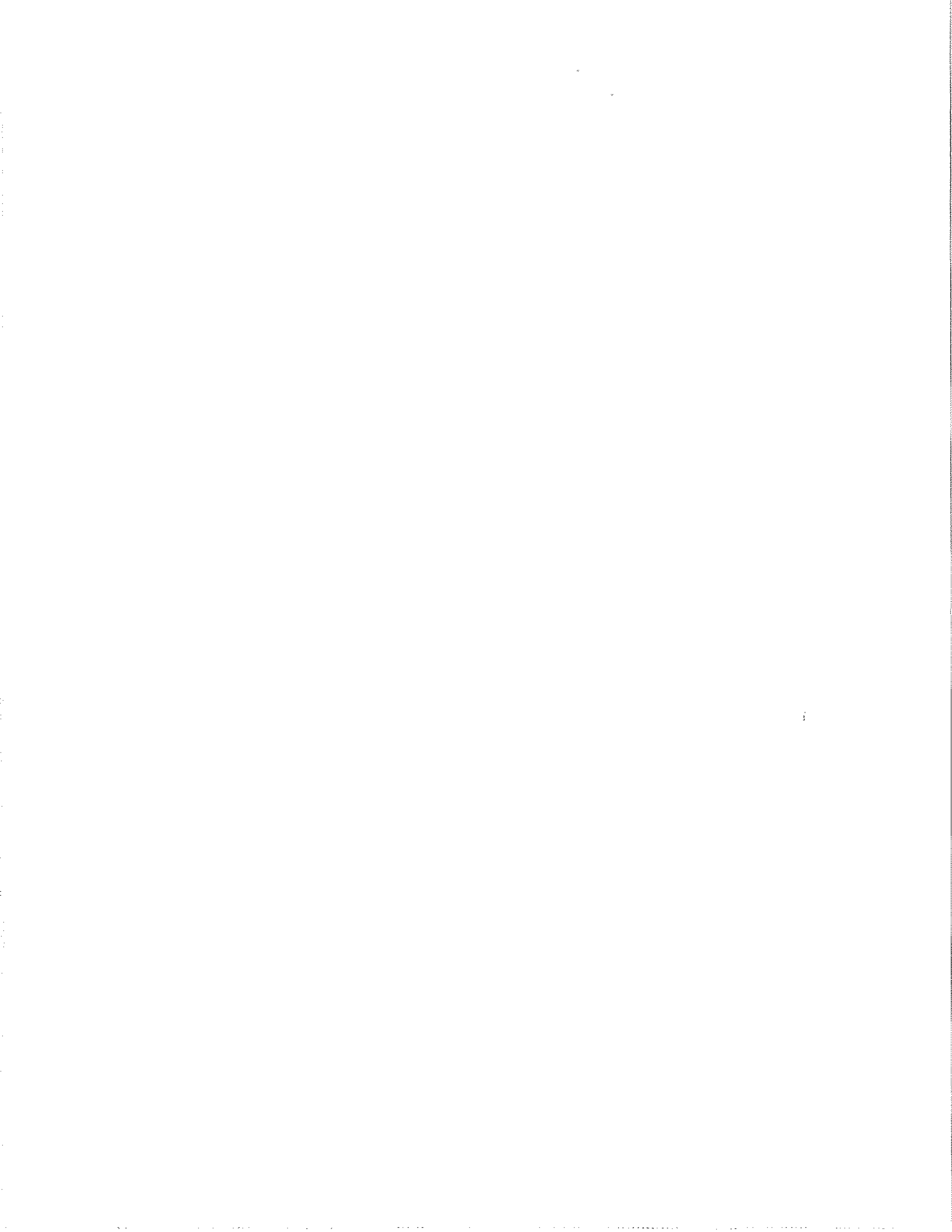

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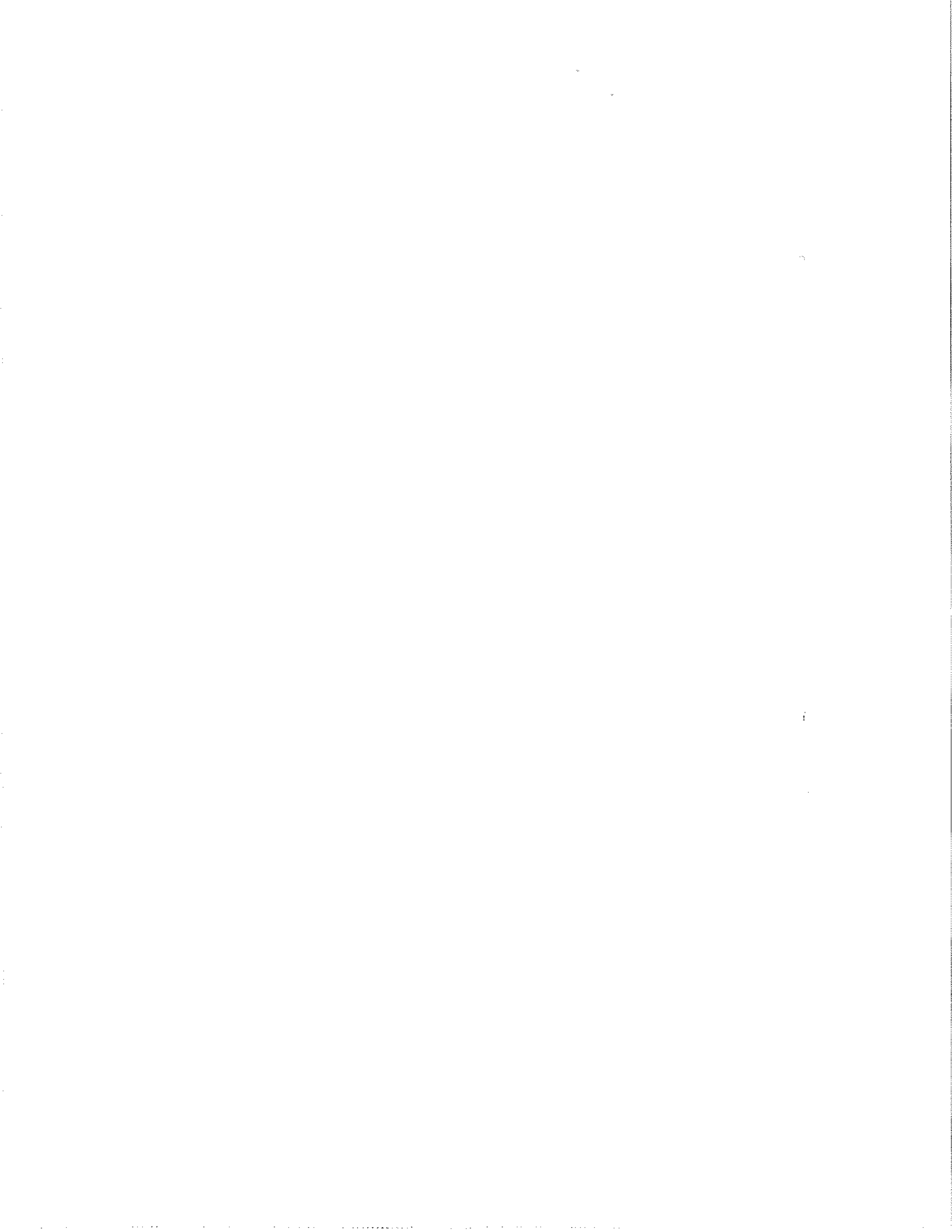
Abstract

Ethical behavior in business is not an accident. It requires vigilance, constant emphasis, and leadership, particularly in the case of shareholder owned, publicly traded companies. This paper systematically provides a roadmap for dealing with the ethical challenges faced by management today. First, working definitions of corporate governance, business ethics, and individual responsibility are established. Second, ten forces that work against ethical behavior in business today are outlined. Finally, ways corporate governance, business ethics, and individual responsibility can hold these forces in check are proffered. The paper concludes with a brief statement as to why all of this matters.



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Introduction

This paper draws from a lecture presented by James Haines as part of the Anderson Chandler Lecture Series at The University of Kansas School of Business on November 8, 2004 and from a lecture to the Robert O. Anderson School and Graduate School of Management at The University of New Mexico on February 9, 2005. The paper's points are primarily directed to shareholder owned, publicly traded companies and are based upon the authors' combined 50 plus years of experience. The paper's goal is to be provocative about ethical behavior in business.

The paper is structured into three parts. First, working definitions of corporate governance, business ethics, and individual responsibility are established. Second, ten forces that work against ethical behavior in business today are outlined. Finally, ways corporate governance, business ethics, and individual responsibility can hold these forces in check are proffered. The paper concludes with a brief statement as to why all of this matters.

The principal point of the paper is that ethical behavior in business is not an accident. It requires vigilance, constant emphasis, and leadership, especially in the case of shareholder owned, publicly traded companies. In "The Irresponsible Investor," Michael Lewis says: "Extreme self-interest is what most investors demand from their corporations ....The pressure applied to people who run public corporations almost requires them to forget how to be good." (Lewis, 2004, p. 70)

Corporate Governance

Corporate governance is a system of checks and balances that is intended to assure compliance with laws and regulations, codes of conduct, and company policies. Broadly speaking, corporate governance practices fit into three categories: board practices, management practices, and enforcement practices. Important examples include:

- Board practices, such as:
  - Independence
  - Formal definition of responsibilities
  - Supervision of audit function (audit committee general oversight and direct control of appointment, compensation, and scope of work of external auditors)
  - Review and approval of long term plans and annual objectives and capital and operating budgets, including Mission, Vision, and Value Statements
  - CEO and officer compensation
- Management practices, such as:
  - Internal controls, including auditor and CEO/CFO certifications
  - Financial reporting controls, including disclosure practices and CEO/CFO certifications
  - Prescribed practices and procedures re business conduct, including code of ethics, insider trading procedures, conflicts
- Enforcement practices, such as:
  - Means for compliance concerns to be reported, investigated, and resolved.

Importantly, a company can possess every recommended governance practice in form and yet possess none of them in substance. For example, almost to the end, many knowledgeable people believed that Enron was a model for good corporate governance. Governance practices, when given substance, strengthen not only compliance with laws and regulations but also creation and execution of strategy.

Corporate governance practices can be encouraged and bolstered by external influences, such as government enforcement of laws and regulations, enforcement of auditing standards, shareholder proposals and litigation, public interest advocacy and litigation, and media coverage. However, design of and strict adherence to corporate governance standards simply to maintain compliance with laws or to minimize litigation and unfavorable media coverage turns upside down the reasoning for establishment of good corporate governance.

Business Ethics

Business ethics, as in "a code of ethics," is an agreed upon set of rules of right conduct. Many professions have a code of ethics as do many business organizations and many individual businesses. Examples include medical ethics, legal ethics, or the code of ethics established by an organization of car dealers or by a particular company. Absent from this list is a universal code of ethics that is applicable to business generally. Perhaps this leaves one with the unsettling conclusion that business ethics is whatever you want it to be!

Is business ethics defined simply by compliance with applicable laws and regulations? If so, what is the meaning of the expression: "It may be legal, but it ain't right!" To most people business ethics is more than simply obeying the law. But what is it? It appears that when most people talk about business ethics, they are talking about some form or extension of their personal code of ethics – modified, perhaps, to take into account their specific business experience.

Individual Responsibility

As it relates to business conduct, individual responsibility involves two duties. The first is to be accountable. "The dog ate my homework" is a trivial though nearly perfect example of what is entailed

here. The duty to be accountable seems nearly forgotten. Contemporary culture nurtures the view that if the dog did eat the homework, then it is the dog's fault and extra credit should be awarded for pain and suffering.

The second duty is for ethical behavior. A company is ethical because its people – directors, officers, and employees – are ethical *as individuals.* When the number of ethical individuals in a company reaches a critical mass, they create a culture that nurtures ethical behavior. A culture can be so sick that it corrupts or at least suppresses ethical individuals. In a sick company, an individual has a duty to resist such corruption or suppression. In a healthy company, an individual has a duty to nurture and protect ethical behavior.

The leaders, especially the senior leaders, almost always have a dominant effect on a company's culture. As such leaders have a special responsibility to embrace and act upon these duties.

Ten Forces That Work Against Ethical Behavior

Every day a senior corporate executive is under enormous pressure to see that her company "makes its numbers." She confronts many difficult choices, any one of which could make or break the numbers. Each of her decisions could be on one side or the other of a very fine and perhaps ambiguous line that sets the boundary between what is legal and illegal, ethical and unethical. She knows that if her company does well, she will do well, but her primary objective is the success of her company. She is loyal to her company, to its employees and customers. She wants to do a good job for them and, in doing that, she wants her company to be profitable for its investors. She is always mindful of her fiduciary responsibility. She is the type of leader and corporate executive who is the focus of discussion here. Most business people are well motivated and intend to conduct business in an ethical way. It is more instructive to

consider the temptations and dilemmas faced by these good and ethical people than by those who have been so much in the headlines in the last few years.

1. Warfare as a business model

The creation and execution of business strategy is often compared to fighting a war. The business literature on strategic planning often draws parallels between successful business strategies and proven military strategies. For example, consider the article "Maneuver Warfare: Can Modern Military Strategy Lead You to Victory?" (Clemons and Santamaria, 2002, pp. 3-11).

The foremost objective in war is destruction of the enemy. When business draws on warfare as a model, the emphasis on destruction can distort a healthy focus on ethical issues and behavior in business. "All is fair in love and war *and business*" is not an appropriate ethical standard for the conduct of business.

2. The struggle for competitive advantage

The ultimate goal for most businesses is to achieve profitable results. In a competitive market, this requires seizing a competitive advantage. Competitive advantage creates winners and losers. Societally (and perhaps from a Darwinian perspective) this is, arguably, a good thing. At an individual level, however, it can be akin to death in the boxing ring. For lack of competitive advantage, companies go bankrupt, individuals lose their livelihoods, communities spiral into oblivion. And for the winners, there is untold prosperity.

In such an environment, the corporate executive is always tempted to conclude that her greatest responsibility is to the survival of her company, her job – her ability to support her family. In the relentless pursuit of competitive advantage, ethical behavior often becomes at best a secondary consideration. Of course, the time for ethical considerations is *before* as well as after prosperity has been assured.

3. The nature of shareholder ownership

At least two aspects of shareholder ownership can work against ethical behavior. First, ethical behavior, if it pays at all, more likely pays only in the long run. Yet the time horizon for shareholders is at the shareholders' option and can be very short. A shareholder can be *in* and *out* of a sizeable position in a company literally in moments.

Second, shareholder ownership in a broadly held company does not entail all the risks and responsibilities normally associated with ownership. Shareholders stand to profit from unethical behavior that is not caught and all they stand to lose is the amount of their investment if it is caught. In fact, shareholders who are smart or lucky enough to get out in time can profit hugely from the fruits of unethical behavior – as many Enron shareholders did. Yet, unless insider knowledge was involved, no attempt to pursue such shareholders through civil or criminal litigation or subject them to reputational disgrace would succeed.

Selling short takes this to an extreme. Short sellers, of course, literally sell before they buy. They do this in anticipation of a falling stock price – perhaps because they believe a company is about to be caught in an unethical practice. Of course, there is no joy in the cold heart of a short seller when a company is publicly exonerated of alleged wrongdoing.

In the market place there is only a very limited economic incentive for shareholders to insist on ethical behavior by the managers of their companies and, perversely, in some cases the market creates opportunities to profit from unethical behavior. Accordingly, shareholders often view questions of ethical behavior on much different terms than managers.

4. The necessity to act without complete information

Most business decisions must be made without complete information. Consequently, there is seldom a clearly right course of action and decisions must be made quickly so that preemptive action can be taken. Often the difference between winning and losing rests on intuition and speed as much as on analytic skill. Not surprisingly, the combination of incomplete information, intuition, and speed elevates the risk of failure. In the hindsight of uninformed observers or opportunistic demagogues, failed decisions often appear to have been foolish, even unethical. Unfortunately, this contributes to the public's perception of the quality of business ethics and can undermine an honest effort to reach an ethical course of action.

5. The limits of economic analysis

In business, there is, as there should be, a strong bias for economic analysis. When information is incomplete, the gaps are plugged with projections and estimates that, at least in part, rely on subjective judgments. The present dollar values of possible options are then estimated. The probability of success for each option is estimated. The former is multiplied by the latter to yield a comparable dollar value for each option. Through this quantitative process, estimates and subjective judgments are converted to seemingly objective dollar values. *But subjective judgments do not become objective simply by translating them into numbers.* More importantly, when some of the options under review require ethical considerations, the difference between right and wrong is clouded when all options are translated into a quantitative order of dollar values. To say that option A contains a moral impediment and option B is pristine is substantially different than to say that option A has a probability adjusted present value of $2 compared to $1.50 for option B. And yet the *virtue* of net present value analysis is touted because it does that very thing. It is plausible that between some boards and their CEO's there is an implicit understanding that ethical issues will be viewed only in economic terms. Would at least part of the compensation for such CEO's then reflect the extent of their perceived exposure to civil or criminal liability or reputational disgrace?

6. Good decisions can have mixed results

Most business decisions are better for some than for others. Strategy is often executed with full knowledge that a successful outcome will not be uniformly good for all concerned. A necessary part of business success is figuring out how to fairly mitigate the harm caused to innocent bystanders. A danger here is that some types of harm cannot be reduced to an economic value. (Hence the need for environmental protection and endangered species laws.) Then mitigation is more difficult, perhaps impossible, and inevitably leads to allegations of unethical behavior.

7.The fog of business

In the documentary film, "The Fog of War," Robert McNamara reflects upon the nature of war. With respect to the firebombing of Japanese cities during World War II, he states: "[General] LeMay said if we'd lost the war we'd all have been prosecuted as war criminals. And I think he's right. He, and I'd say I, were behaving as war criminals. LeMay recognized that what he was doing would be thought immoral if his side had lost. But what makes it immoral if you lose and not immoral if you win?" (The Fog of War, 2003)

Consistent with the economic analysis that drives business decisions in the first place, business success is measured foremost by economic results. *When it is said that a company has had a good quarter, no one interprets that to mean that its decisions for that quarter have been ethical.* Corporate executives are rewarded for profitable results and those results are called good; there is concern for the real goodness of their behavior only when they are caught in some malfeasance and only then if profits decline.

In "The Irresponsible Investor" Michael Lewis writes that when investors lose money, "It is at that moment – and not a minute before – that they discover the novel idea that businessmen in possession of other people's capital should be held to the highest ethical standards." (Lewis, 2004 p. 70)

The recent focus on the importance of business ethics is almost perfectly correlated with the large losses in shareholder wealth that occurred in late 2000 and 2001. During the booming '90's when shareholders and employees were getting fabulously rich and the government's tax coffers were overflowing, questions about business ethics were not considered important. This begs the obvious variant of McNamara's question: But what makes it immoral if you lose money and not immoral if you make money?

8. Insider stock ownership

It is an article of faith that the most effective way to *align* the interest of management and the board with the interest of shareholders is to require management and the board to own a significant amount of their company's stock. This is appropriate within certain limitations. Problems can occur however when board members or management have most of their wealth tied up in their company's stock. It is not a certainty that directors or executives will necessarily compromise personal integrity to avoid a financial loss but it seems reasonable to speculate that the likelihood increases as the size of the potential loss increases or the size of the insider stock holding increases.

A more difficult situation can arise when price targets must be met to trigger the vesting of share grants or options. It is often the case that actions can be taken that will boost the near term market price of a company's stock at the risk of depressing longer term price appreciation. Compensation experts might say that this problem results from a poorly structured compensation plan; more likely, the fact that it is acknowledged as a problem in the first place is the best evidence that large stock holdings by insiders can be a force against ethical behavior. Furthermore, if the executive resists these temptations and sees her personal wealth substantially diminishing, it seems likely that her business focus will be distracted by personal financial problems.

9. The search for truth through litigation

Litigation is the last resort for the resolution of business disputes. In litigation the truth is found, at best indirectly, through the advocacy of adverse interests that may or may not benefit from the full truth being found. In a different context, the authors of The Smartest Guys in the Room described this as a process in which "…telling the truth is the same thing as making sure that no one can prove you lied." (McClean and Elkind, 2003, p. 406) This is not a reliable way to establish a benchmark for ethical conduct.

10. Lax or uneven enforcement of the law

A more troubling aspect of the legal system is the uneven enforcement of laws and regulations. When the enforcement of laws and regulations is lax or uneven tremendous competitive advantages can emerge. Should company A have an advantage over company B simply because, in an environment of lax enforcement, A is willing to violate the law and B is not? When everyone else is doing it and getting away with it and making a profit from it, how does the CEO convince her shareholders that it is better to take the high road?

The purpose in the second part of this article has been to describe ten forces that, if unchecked, virtually eliminate the possibility that a company's leaders and executives will persistently make ethical decisions. Business decisions often must be made in the midst of the most severe weather and, ultimately, the sun nearly always shines more brightly on winners than on losers. In fundamental ways, therefore, when business decisions are made, ethical considerations, if they appear at all, often are separated from and secondary to economic considerations. One might conclude that if these forces are that powerful only through the most radical reforms would ethical business behavior be possible. But, for example, eliminating the need to struggle for competitive advantage would require abandoning the bedrock of capitalism – the competitive marketplace. In no way should this approach be recommended.

The Synergy of Corporate Governance, Business Ethics, and Individual Responsibility

Corporate governance, business ethics, and individual responsibility are a three-legged pedestal upon which the entire structure of a company stands. Take one away and the danger of collapse is lurking. Take two away and only the most incredible balancing act will keep the company upright. Take all three away and collapse is certain.

1. Independence Is the Key to Effective Governance

Among all the corporate governance practices, independence is the lynchpin – independence in the relationships between the board and management, between the auditors, including the internal auditors, and management, and between the board and the auditors. Independence in these relationships is a strong antidote to the dark side of the ten forces; without independence, no corporate governance practice will work to its full potential in checking those forces. A company's board must be the primary guardian of independence.

2. An Independent Board of Directors

The objective is to have a board that is not unduly influenced by management. In some respects form can contribute to this objective. The position of chairman can be separated from the position of CEO. The recruitment of new directors can be directed and controlled by a committee of independent directors, not the CEO. The number of inside directors can be limited – perhaps simply to the CEO. Some board committees can be composed only of independent directors. At a minimum, these would include the audit, nomination, and compensation committees. The board can meet regularly in executive session. The board can be declassified so that every member stands for re-election every year. The board members can have unfettered access to all members of the management team. And, finally, the board can control the process of CEO succession.

These matters of form and structure add value only if they are complemented by matters of substance. True independence only comes when directors have relevant and diverse experience, sound knowledge of

the business, and an inquisitive temperament, and only then if they devote the time necessary to monitor management performance, deliberate about issues of strategic importance, and actively review long term plans. True independence means that a board regularly evaluates its own performance as well as the performance of the CEO. Without these substantive attributes, a board's independence in form would lead only to chaos.

While board independence is a good thing, independence alone is not the purpose of a board. The purpose is to guide a company's management in the resolution of difficult problems and in the development and implementation of strategy and ultimately to profitable results. And to do all this in a way that assures full disclosure and compliance with applicable laws and regulations. An independent board is more likely to critically review and challenge management than a board that is *too close* to management. It is also true that when taken to an extreme board independence can be dysfunctional and even destructive.

To achieve desired results, there must be a high level of mutual respect, confidence, goodwill, and collegiality between a board and a management team; there must be a willingness to listen to each other's points of view; and each must be committed to the mission, vision, and values of the company. If these qualities are not present, board independence will lead to cynicism, infighting, second guessing, and to a management style that is defensive and geared to achieving peace with its board rather than success in the marketplace.

3) Independent Auditors

The independence of the audit function begins with the new Sarbanes Oxley related requirements. The Sarbanes Oxley Act established requirements for audit committee members and limited the scope of work a company's external auditors can do for the company. Requiring the audit committee to be responsible for the retention, supervision, and compensation of the auditors substantially reduces the ability of management to unduly influence the audit process. Limiting the external auditor's scope of work to the

financial audit and tasks directly related to the audit substantially reduces potential conflicts and appropriately returns the auditor's focus exclusively to the audit function. Regular, substantive meetings between the audit committee of the board and the external auditor can only reinforce this focus and independence from management. Requiring the board to have a designated financial expert can greatly enhance the effectiveness of the board's supervision of the external auditor.

Although not required by the recent reforms, the increased independence of the internal audit function can also be an important part of effective corporate governance. The lead internal auditor should have the experience, status, and staff support to command respect and effectively carry out a comprehensive audit plan. As with the external audit function, the internal audit function – as to form and substance – should report to the audit committee of the board. There should be regular and unfettered contact between the internal auditors and the audit committee of the board. While management should have input to the development of the annual audit plan, final plan approval should be controlled by the audit committee. The Sarbanes Oxley Act also established the Public Company Accounting Oversight Board (PCAOB), an entirely new regulator, which establishes and enforces standards for firms that audit the financial statements of publicly traded companies. The PCAOB is intended to assure quality as well as independence.

Business Ethics Begins with an Unwavering Commitment to Values

Board and auditor independence, as well as other governance practices, are of little value if there is not a common and clear understanding of a company's values and its code of conduct. This begins with the governance practice of establishing a statement of values and a formal code of ethics. *Starting with the senior leaders, all individuals in a company must have an unwavering commitment to its values and its code of ethics.* Without that commitment there is no rudder and the board and the auditors in their independence will be reduced to a police force at best.

For a code of ethics to be effective, the senior leaders of a company must openly model it in every aspect of their work. There must be a training and enforcement function. There must be a means of interpretation and adaptation when new or unexpected circumstances arise. There must be recognition that the importance of ethical behavior is independent of profit goals. *Ethical behavior is important for its own sake.* A company's values and its code of ethics must be sources of pride and adherence to them must be a meaningful part of performance evaluations.

In the book about Enron, The Smartest Guys in the Room, the authors describe a business environment entirely devoid of concern for ethical behavior: "Even before the dawning of the 1990s bull market, a new ethos was gradually taking hold in corporate America, according to which anything that wasn't blatantly illegal was therefore okay – no matter how deceptive the practice might be. Creative accountants found clever ways around accounting rules and were rewarded for doing so. Investment bankers invented complex financial structures that they then sold to eager companies, all searching for ways to make their numbers look better." (McClean and Elkind, 2003, p. 406)

To be ethical in business requires a conscious choice, a relentless commitment because all the positive incentives are for economic results, not ethical results.

Individual Responsibility Makes It Work

Individual responsibility is the third leg of the pedestal. Ethical conduct involves much more than simply a philosophical consideration of what is the right way to behave. It involves much more than simply putting words on paper in a corporate value statement or a code of ethics. In business, ethical considerations are important only if in fact they govern conduct and lead to action. The corporate

executive is not ethical simply because she knows the difference between right and wrong. She is ethical when she can be depended upon to always do the right thing.

The emphasis is on "always." It is not what she does 99 times out of 100 that earns a reputation of being ethical; it is what she does 100 times out of 100. After all, the cleverest and most effective liars tell the truth most of the time.

It is individual responsibility – a sense of duty to be accountable and to be ethical – that will keep the corporate executive on the right course. She knows that the recent ethical crises in corporate America did not germinate from within; rather, they spread from the top. She knows that unethical behavior at the very top will at a minimum demoralize her company's employees and it may corrupt them. She knows that the responsibility for ethical behavior in her company begins with her and her senior colleagues.

She always keeps these three lessons in mind:

- Ethical behavior does not guarantee profitable results and it does not prevent unprofitable results.
- The corollary is also true: Profitable results do not prove ethical behavior and unprofitable results do not prove unethical behavior.
- Ethical behavior is good for its own sake.

Fundamentally, the persistence of ethical conduct in an organization depends upon some recognition of those principles and the devotion of its leaders to ethical conduct as a way of life. This requires that the leaders of an organization periodically reflect in a deliberate way upon what it means to lead an ethical life. Such reflection can be a highly personal and private matter. Within very broad limits, there are many sources to which a person can go for moral guidance. What is important is that the members of an

organization, especially its leaders, are able to draw upon such sources when confronted with an ethical conundrum.

The senior executive recognizes that she is fallible, that she can make mistakes and even that she can be tempted to step across the line. She is aware of the numerous and powerful forces that work to pull her across the line. She knows that she is a strong person but she knows that even the strongest person can be broken. What does she do? She insists on a structure within which her strength is fortified. She wants an independent board of informed, involved, and expert directors. She wants her company to have a clear statement of values and a comprehensive code of ethics. She wants them to be respected and enforced. She knows finally that within this structure she has the greatest likelihood of long-term success.

Finally, why does all of this matter?

It is tempting to say that business people should behave ethically because in the long run ethical behavior will produce better economic results than unethical behavior. As a matter of probability, that is the case. But there are also situations in which ethical people have economically failed in the long run and unethical people have succeeded. If ethical behavior is pursued simply out of a calculated belief that in the long run it is more likely to produce superior economic results, what is the result when that does not happen? If good economic results are a justification for ethical behavior then poor economic results can be a justification for stepping across the line.

"Well, it's a jungle out there, isn't it?" Perhaps that rhetorical question is a way to explain the reason for unethical behavior. After all, anything goes in a jungle, right? *If it is a jungle in which only the unethical can survive, then none of what is written here matters.* But perhaps that question has a more subtle meaning: it's a jungle because of the unethical behavior. If it's a jungle, it's a jungle because of collective individual choices. And individuals can choose otherwise.

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