CHAPTER 7

ORGANIZATIONAL FACTORS: THE ROLE OF ETHICAL CULTURE AND RELATIONSHIPS

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CHAPTER OBJECTIVES

- To understand the concept of corporate culture
- To examine the influence of corporate culture on business ethics
- To determine how leadership, power, and motivation relate to ethical decision making in organizations
- To assess organizational structure and its relationship to business ethics
- To explore how the work group influences ethical decisions
- To discuss the relationship between individual and group ethical decision making

CHAPTER OUTLINE

Defining Corporate Culture

The Role of Corporate Culture in Ethical Decision Making

Ethical Frameworks and Evaluations of Corporate Culture

Ethics as a Component of Corporate Culture

Compliance versus Value-based Ethical Cultures

Differential Association

Whistle-Blowing

Leaders Influence Corporate Culture

Power Shapes Corporate Culture

Motivating Ethical Behavior

Organizational Structure and Business Ethics

Group Dimensions of Corporate Structure and Culture

Types of Groups

Group Norms

Variation in Employee Conduct

Can People Control Their Own Actions within a Corporate Culture?

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AN ETHICAL DILEMMA*

Dawn Prarie had been with PCA Health Care Hospitals for three years and had been promoted to marketing director in the Miami area. She had a staff of 10 and a fairly healthy budget. Dawn's job was to attract more patients to the HMO while helping keep costs down. At a meeting with Dawn, Nancy, the vice president, had explained the ramifications of the Balanced Budget Act and how it was affecting all HMOs. "Being here in Miami does not help our division," she told Dawn. "Because of this Balanced Budget Act, we have been losing money on many of our elderly patients. For example, we used to receive $600 or more a month, per patient, from Medicare, but now our minimum reimbursement is just $367 a month!

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I need solutions, and that's where you come in. By the end of the month, I want a list of things that will help us show a profit. Anything less than a positive balance sheet will be unacceptable."

It was obvious that Nancy was serious about cutting costs and increasing revenues within the elderly market. That's why Dawn had been promoted to marketing director. The first thing Dawn did after the meeting with Nancy was to fire four key people. She then gave their duties to six others who were at lower salaries, and put the hospital staff on notice that changes would be occurring at the hospital over the next several months. Three weeks later, Dawn presented Nancy with an extensive list of ideas. The list included these suggestions:

1. Trimming some prescription drug benefits
2. Reducing redundant tests for terminal patients
3. Hiring physician assistants to see patients but billing patients at the physician rate
4. Allowing physicians to buy shares in PCA, thus providing an incentive for bringing in more patients
5. Sterilizing and reusing cardiac catheters
6. Instituting a one-vendor policy on hospital products to gain quantity discounts
7. Prescreening "insurance" patients for probability of payment

Dawn's assistants felt that some of the hospital staff could be more aggressive in the marketing area. They urged using more promotional materials, offering incentives for physicians who suggested PCA or required their patients to be hospitalized, and prescreening potential clients into categories. "You see," said Ron, one of Dawn's staff, "we feel that there are four types of elderly patients. There are the healthy elderly, whose life expectancies are 10 or more years. There are the fragile elderly, with life expectancies of two to seven years. Then there are the demented and dying elderly, who usually have one to three years. Finally, we have the high-cost or uninsured elderly. Patients who are designated healthy would get the most care, including mammograms, prostate-cancer screening, and cholesterol checks. Patients in the other categories would get less."

As she implemented some of the recommendations on Dawn's list, Nancy also launched an aggressive plan to destabilize the nurses' union. As a result, many nurses began a work slowdown and were filing internal petitions to upper management. Headquarters told Nancy to give the nurses and other hospital staff as much overtime as they wanted but not to hire anyone new. One floor manager suggested splitting up the staff into work teams, with built-in incentives for those who worked smarter and/or faster. Nancy approved the plan, and in three months productivity had jumped 50 percent, with many of the hospital workers making more money. The downside for Nancy was an increase in worker-related accidents.

When Dawn toured the hospital around this time, she found that some of the most productive workers were using substandard procedures and poorly made products. One nurse said, "Yes, the surgical gloves are somewhat of a problem, but we were told that the quality met the minimum requirements and so we have to use them." Dawn brought this to Nancy's attention, whereupon Nancy drafted the following memo:

Attention Hospital Staff

It has come to management's attention that minor injuries to staff and patients are on the rise. Please review the Occupational Safety and Health Administration guidelines, as well as the standard procedures handbook, to make sure you are in compliance. I also want to thank all those teams that have been keeping costs down. We have finally gone into the plus side as far as profitability. Hang on, and we'll be able to stabilize the hospital to make it a better place to care for patients and to work.

At Nancy's latest meeting with Dawn, she told Dawn, "We've decided to use your staff's segmentation strategy for the elderly market. We want you to develop a questionnaire to prescreen incoming HMO patients, as well as existing clients, into one of the four categories so that we can tag their charts and alert the HMO physicians to the new protocols. Also, because the recommendations that we've put into practice have worked so well, we've decided to use the rest of your suggestions. The implementation phase will start next month. I want you, Dawn, to be the lead person in

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developing a long-term strategy to break the unions in the hospital. Do whatever it takes. We just need to do more with less. I'm firm on this—so you're either on board or you're not. Which is it going to be?"

QUESTIONS | EXERCISES

1. Discuss PCA Health Care Hospitals' corporate culture and its ethical implications.
2. What factors influence Dawn's options?
3. Discuss the issue of for-profit versus nonprofit healthcare facilities.
4. If you were Dawn, what information would you like to have to help you make your decisions?

*This case is strictly hypothetical; any resemblance to real persons, companies, or situations is coincidental.

Companies are much more than structures in which we work. Although they are not alive, we attribute human characteristics to them. When times are good, we say the company is "well"; when times are not so good, we may try to "save" the company. Understandably, people have strong feelings about the place that provides them with income and benefits, challenges, satisfaction, self-esteem, and often lifelong friendships. In fact, excluding time spent sleeping, we spend almost 50 percent of our lives in this second "home" with our second "family." It is important, then, to examine how the culture and structure of these organizations influence the ethical decisions made within them.

In the ethical decision-making framework described in Chapter 5, we introduced the concept that organizational factors and interpersonal relationships influence the ethical decision-making process. In this chapter, we take a closer look at corporate culture and the ways a company's values and traditions can affect employees' ethical behavior. We also discuss the role of leadership in influencing ethical behavior within a company. Next we describe two organizational structures and examine how they may influence ethical decisions. We discuss new organizational structures that have been created to address the organization's corporate responsibility to employees and other stakeholders. Then we consider the impact of groups within organizations. Finally, we examine the implications of organizational relationships for ethical decision making.

DEFINING CORPORATE CULTURE

Culture is a word that people generally use in relation to genealogy, country of origin, language and the way people speak, the types of food they eat, and other customs. Many define culture as nationality or citizenship. Values, norms, artifacts, and rituals all play a role in culture. Chapter 5 defined corporate culture as a set of values, norms, and artifacts, including ways of solving problems that members (employees) of an organization share.

Corporate culture is also "the shared beliefs top managers in a company have about how they should manage themselves and other employees, and how they should conduct their business(es)."[1] Mutual of Omaha incorporates the concept of corporate culture into its mission statement. Its intent is "to build a corporate culture that respects and values the unique strengths and cultural differences of our associates, customers and community."[2] Its executives believe that the company's corporate culture provides the foundation for its work and objectives, so much so that the organization has adopted a set of core values

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called "Values for Success." Mutual of Omaha feels that these values form the foundation for a corporate culture that will help the organization realize its vision and achieve its goals. Corporate culture is exhibited through the behavioral patterns, concepts, documents such as codes of ethics, and rituals that emerge in an organization.[3] It gives the members of the organization a sense of meaning and purpose and familiarizes them with the organization's internal rules of behavior.[4]

Southwest Airlines has a very strong and friendly, fun-loving organizational culture that dates all the way back to the days of its key founder Herb Kelleher. Kelleher became legendary for appearing in a dress and feather boa and joining baggage handlers on Southwest flights. He organized an awards ceremony for employees that many felt rivaled the Academy Awards. He treated his employees like family. Today, Southwest continues that legacy. For instance, pilots willingly and enthusiastically support the "Adopt a Pilot" program, in which students in classrooms around the country adopt a Southwest pilot for a four-week educational and mentoring program. The pilots volunteer in the students' classrooms and send e-mails and postcards to a variety of destinations. Southwest's culture allows it to attract some of the best talent in the industry.[5] Values, beliefs, customs, rules, and ceremonies that are accepted, shared, and circulated throughout an organization represent its culture. All organizations, not just corporations, have some sort of culture, and therefore we use the terms *organizational culture* and *corporate culture* interchangeably.

> **"All organizations, not just corporations, have some sort of culture."**

A company's history and unwritten rules are a part of its culture. For many years, IBM salespeople adhered to a series of unwritten standards for dealing with clients. The history or stories passed down from generation to generation within an organization are like the traditions that are perpetuated within society at large. Henry Ford, the founder of Ford Motor Co., left a legacy that emphasized the importance of the individual employee. Henry Ford pioneered the then-unheard-of high wage of $5 a day in the early years of the twentieth century, and current company chairman William Clay Ford, Jr., continues to affirm that positive employee relationships create a sustainable competitive advantage for the company.[6] William Ford has maintained his grandfather's legacy by taking a leadership role in improving vehicle fuel efficiency while reducing emissions. Ford is trying to become an industry leader in sustainability through initiatives such as its Go Green Dealership Program. This voluntary program offers dealers the chance to receive energy assessments from Ford's sustainability experts with the intent of increasing their energy efficiency. For dealers that choose to make changes, Ford experts provide guidance on sustainable product selections and state and federal tax incentives.[7]

Leaders are responsible for the actions of their subordinates, and corporations should have ethical corporate cultures. For this reason, the definition and measurement of a corporate culture is very important. It is defined in the Sarbanes–Oxley Act, which was enacted after the Enron, Tyco International, Adelphia, Peregrine Systems, and WorldCom scandals. The characteristics of an ethical corporate culture were codified within the **Sarbanes–Oxley 404** compliance section. This section includes a requirement that management assess the effectiveness of the organization's internal controls and commission an audit of these controls by an external auditor in conjunction with the audit of its financial statements. Section 404 forces firms to adopt a set of values that must form a portion of the company's culture. The evaluation of corporate culture it mandates is meant to provide insight into the character of an organization, its ethics, and its level of openness.

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Compliance with Sarbanes–Oxley 404 requires not merely changes in accounting but a change in corporate culture. The intent is to expose mismanagement, fraud, theft, abuse, and to sustain a corporate culture that does not allow these conditions and actions to exist. Many consulting companies that have filled the need of companies wanting to comply have not understood what “culture” means in this case. They have sought to provide direction and criteria for improving an organization’s ability to manage risk, not its ethics. In many firms, an ethical corporate culture is measured in the following ways:

- Management and the board demonstrate their commitment to strong controls through their communications and actions.
- Every employee is encouraged and required to have hands-on involvement in the internal control system.
- Every employee is encouraged and empowered to report policy exceptions.
- Employees are expected to be in the communication loop through resolutions and corrective actions.
- Employees have the ability to report policy exceptions anonymously to any member of the organization, including the CEO, other members of management, and the board of directors.[8]

The problem with these standards of measurement is that they evaluate merely risk and compliance. They are not a complete measure of the aspects of a company that make up its ethical culture. Yet many assume that the four afore mentioned items define an ethical corporate culture. Since values, norms, and artifacts are the three major components of culture, all of these elements are important in measuring an ethical culture.

In the past 50 years, scholars have developed at least 164 distinct definitions of culture. More recent reviews indicate that the number of definitions has only been increasing.[9] While these definitions of culture vary greatly, they share three common elements: (1) “culture is shared among individuals belonging to a group or society,” (2) “culture is formed over a relatively long period of time,” and (3) “culture is relatively stable.”[10]

Different models of culture, and consequently different instruments for measuring it, focus on various levels (national, organizational, individual) and aspects (values, practices, observable artifacts and rituals, underlying implicit assumptions). Geert Hofstede, who researched IBM’s corporate culture, described it as an onion with many layers, representing different levels within the corporation.[11] Today, IBM describes its culture as a culture of trust. The company has adopted IBM Business Conduct Guidelines, which describe ethics and compliance issues in-depth and provide direction for employees on how to deal with observed misconduct. The company also created an online reporting system that allows employees worldwide to raise issues and report concerns. These measures serve to advance IBM’s goal of ensuring that its relationships with stakeholders “are truly built on trust.”[12] Many in business define ethics as what society considers right or wrong and develop measures that manage the risk of misconduct. Managing risk is not the same as understanding what makes up a firm’s culture, however. We know for certain that culture has a significant effect on the ethical decision-making process of those in business. Ethical audits, ethical compliance, and risk culture surveys may be good tools, but in and of themselves they are not useful in helping to define organizational culture or in explaining what makes a particular organizational culture more ethical or unethical.

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THE ROLE OF CORPORATE CULTURE IN ETHICAL DECISION MAKING

Corporate culture has been associated with a company's success or failure. Some cultures are so strong that to outsiders they come to represent the character of the entire organization. For example, Levi Strauss, Ben & Jerry's Homemade Ice Cream, and Hershey Foods are widely perceived as casual organizations with strong ethical cultures, whereas Lockheed Martin, Procter & Gamble, and Texas Instruments are perceived as having more formal ethical cultures. The culture of an organization may be explicitly articulated or left unspoken.

Explicit statements of values, beliefs, and customs usually come from upper management. Memos, written codes of conduct, handbooks, manuals, forms, and ceremonies are all formal expressions of an organization's culture. Many of these statements can be found on company websites, like that of Wells Fargo (Table 7.1).

Corporate culture is often expressed informally, for example through statements, both direct and indirect, that communicate the wishes of management. In some companies, shared values are expressed through instituting informal dress codes, working late, and participating in extracurricular activities. Corporate culture can even be expressed through gestures, looks, labels, promotions, programs, and legends (or the lack thereof). Phil Knight, Nike co-founder and sports icon, has created a strong and appealing organizational culture. Knight seeks out new employees on one of their first few days on the job to "borrow $20 for lunch." The unsuspecting new employees are astounded that Knight spoke to them. Knight uses that tactic as a subtle way to let new employees know that they are on his radar. Interestingly, Knight has never paid back any of the employees. This ritual becomes a source of camaraderie among employees. It has contributed to building trust and commitment, and differentiates Nike's organizational culture from that of its competitors.

The "tone at the top" is a determining factor in the creation of a high-integrity organization. When leaders are perceived as trustworthy, employee trust increases; leaders are seen as ethical and as honoring a higher level of duties.[13] In a KPMG Forensic Integrity Survey (Figure 7.1), employees were asked whether their CEO and other senior executives

TABLE 7.1 Wells Fargo's Ethics Values

We behave ethically when we:
• Value and reward open, honest, two-way communication.
• Be accountable for, and proud of, our conduct and our decisions.
• Only make promises we intend to keep—do what we say we'll do. If things change, let people know.
• Share information with our colleagues that they need, and let them know if things change.
• Avoid any actual or perceived conflict of interest.
• Comply with the letter and the spirit of the law.
• Acknowledge and apologize for our mistakes, and learn from our errors so we don't make them again.

Source: "Our values: What we stand for," Wells Fargo, https://www.wellsfargo.com/invest_relations/vision_values/6 (accessed March 8, 2011).

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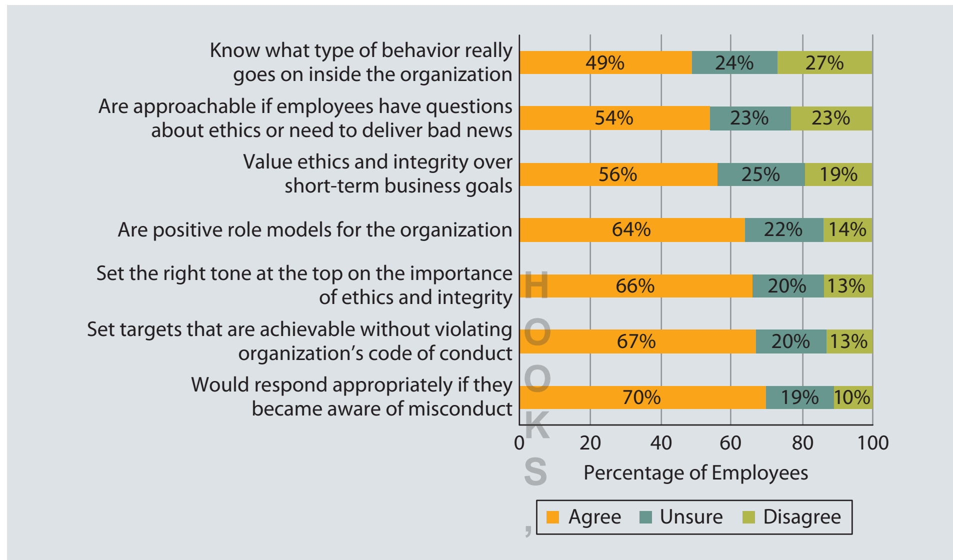
FIGURE 7.1 Perceived Tone and Culture, Tone at the Top, and Perceptions of the CEO and Other Senior Executives



Source: "Forensic Integrity Survey 2008–2009," KPMG, http://www.kpmg.com/SiteCollectionDocuments/Integrity-Survey-2008-2009.pdf (accessed August 19, 2009).

exhibited characteristics attributable to personal integrity and ethical leadership. Nearly two-thirds of employees believed that their leaders served as positive role models for their organizations. However, roughly half exhibited a lack of confidence (based on "unsure" and "disagree" responses) that their CEOs knew about behaviors further down in the organization. Overall, nearly two-thirds of employees agreed that their leaders set the right tone at the top, leaving one-third unsure or in disagreement.

Ethical Frameworks and Evaluations of Corporate Culture

Corporate culture has been conceptualized in many ways. For example, N. K. Sethia and Mary Ann Von Glinow have proposed two basic dimensions to describe an organization's culture: (1) concern for people—the organization's efforts to care for its employees' well-being, and (2) concern for performance—the organization's efforts to focus on output and employee productivity.[14] Figure 7.2 provides examples of companies that display elements of these four organizational cultures.

As Figure 7.2 shows, the four organizational cultures can be classified as apathetic, caring, exacting, and integrative. An **apathetic culture** shows minimal concern for either people or performance. In this culture, individuals focus on their own self-interest. Apathetic tendencies can occur in almost any organization. Steel companies and airlines were among the first to freeze employee pensions to keep their businesses operating. Sweeping changes in corporate America are affecting employee compensation and retirement plans. Simple gestures of appreciation, such as anniversary watches, rings, dinners, or birthday cards for family members, are being dropped. Many companies view long-serving employees as dead wood and do not take into account past performance. This attitude demonstrates the companies' apathetic culture.

A caring culture exhibits high concern for people but minimal concern for performance issues. From an ethical standpoint, the caring culture seems very appealing. However, it is

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FIGURE 7.2 Company Examples of the Four Organizational Cultures

Ben & Jerry's—A Caring Culture Ben & Jerry's embraces community causes, treats its employees fairly, and expends numerous resources to enhance the well-being of its customers.	*Starbucks—An Integrative Culture* Starbucks is always looking for ways to expand and improve performance. It also exhibits a high concern for people through community causes, sustainability, and employee health care.
Countrywide Financial—An Apathetic Culture Countrywide seemed to show little concern for employees and customers. The company's culture appeared to encourage unethical conduct in exchange for profits.	*United Parcel Systems—An Exacting Culture* Employees are held to high standards to ensure maximum performance, consistency of delivery, and efficiency.

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difficult to find nationally recognizable companies that maintain little or no concern for performance. In contrast, an **exacting culture** shows little concern for people but a high concern for performance; it focuses on the interests of the organization. United Parcel Service (UPS) has always been very exacting. With over 8.5 million daily customers in over 200 countries, UPS knows just how many employees it needs to move its 15.6 million pieces per day worldwide.[15] To combat the uncaring, unsympathetic attitude of many of its managers, UPS has developed a community service program for its employees. Global Volunteer Week gives UPS employees around the world the opportunity to help paint schools, renovate shelters, and assist with many other needed projects within their communities. An early innovator, UPS tested ways to use alternate fuels in the 1930s. Now the company operates one of the largest private alternative fleets in the transportation industry with over 1,900 compressed natural gas, liquefied natural gas, hybrid-electric, electric, and propane-powered vehicles.[16]

An **integrative culture** combines a high concern for people with one for performance. An organization becomes integrative when superiors recognize that employees are more than interchangeable parts—that employees have an ineffable quality that helps the firm meet its performance criteria. Many companies, such as the Boston Consulting Group (BCG), have such a culture. The Boston Consulting Group rated second among *Fortune*'s "Best Companies to Work for." BCG is a financially successful global consulting firm with a strong reputation that specializes in business strategy. The company values its employees and creates significant mentorship opportunities and extensive training that allow employees to develop rapidly. In addition, the company provides high pay and refused to lay off employees during the downturn. BCG also has a strong commitment for people outside its immediate circle. The company removed some of its staff from projects so that they could help in the aftermath of the 2010 Haitian earthquake.[17]

Companies can classify their corporate culture and identify its specific values, norms, beliefs, and customs by conducting a cultural audit. A **cultural audit** is an assessment of an organization's values. It is usually conducted by outside consultants but may be performed internally as well. Communication about ethical expectations and support from top management help to identify a corporate culture that either encourages ethical conduct or leads to ethical conflict.[18]

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Ethics as a Component of Corporate Culture

As indicated in the framework presented in Chapter 5, ethical culture, the ethical component of corporate culture, is a significant factor in ethical decision making. If a firm's culture encourages or rewards unethical behavior, its employees may well act unethically. If the culture dictates hiring people who have specific, similar values and if those values are perceived as unethical by society, society will view the organization and its members as unethical. Such a pattern often occurs in certain areas of marketing. For instance, salespeople may be seen as unethical because they sometimes use aggressive selling tactics to get customers to buy things they do not need or want. If a company's primary objective is to make as much profit as possible through whatever means, its culture may foster behavior that conflicts with stakeholders' ethical values. After the *Deepwater Horizon* disaster in 2010, the culture of BP, with its emphasis on financial performance, became the focus of criticism. BP has had a history of accidents, explosions, and other events over the last six years. Even in 2011, BP was accused of criminal negligence regarding previous oil spills in Alaska. These events lead to questions about how the BP culture views the prevention of accidents and environmental damage.[19]

On the other hand, if an organization values ethical behaviors, it will reward them. It is important to handle recognition and awards for appropriate behavior in a consistent and balanced manner. All employees should be eligible for recognition, the behaviors or actions being acknowledged should be noted, anyone performing at the threshold level should be acknowledged, and praise or rewards should be given as close to the performance as possible.[20] FedEx's Bravo Zulu award is one example of company recognition. The award is given to employees who demonstrate exceptional performance above and beyond job expectations. Rewards for recipients can include cash bonuses, theater tickets, gift certificates, and more. By rewarding employees who go above their normal duties, FedEx provides motivation for other workers to strive for excellent work conduct.[21]

Management's sense of an organization's culture may not be in line with the values and ethical beliefs that are actually guiding a firm's employees. Table 7.2 provides an example of a corporate culture ethics audit. Companies interested in assessing their culture can use this tool and benchmark against previous years' results to measure organizational improvements. Ethical issues may arise because of conflicts between the cultural values perceived by management and those actually at work in the organization. For example, managers may believe that their firm's organizational culture encourages respect for peers and subordinates. On the basis of the rewards or sanctions associated with various behaviors, however, the firm's employees may believe that the company encourages competition among organizational members. A competitive orientation may result in a less ethical corporate culture. This was the case at Enron when the employees in the lowest 20 percent for performance were fired. On the other hand, employees appreciate working in an environment that is designed to enhance workplace experiences through goals that encompass more than just maximizing profits.[22] Therefore it is very important for top managers to determine their organization's culture and to monitor its values, traditions, and beliefs to ensure that they represent the desired culture. It is also important to note that if corporate communication to improve social responsibility and ethics is reactive or focused on avoiding negative consequences, it may not make a significant contribution to creating an ethical culture. Reactive communication without commitment could therefore fail to improve business ethics.[23] The rewards and punishments imposed by an organization must also reflect the culture that those at the top wish to create. As two business ethics experts

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TABLE 7.2 Corporate Culture Ethics Audit

Answer Yes or No to each of the following questions*		
Yes	No	Has the founder or top management of the company left an ethical legacy to the organization?
Yes	No	Does the company have methods for detecting ethical concerns both within the organization and outside it?
Yes	No	Is there a shared value system and understanding of what constitutes appropriate behavior within the organization?
Yes	No	Are stories and myths embedded in daily conversations about appropriate ethical conduct?
Yes	No	Are codes of ethics or ethical policies communicated to employees?
Yes	No	Are there ethical rules or procedures in training manuals or other company publications?
Yes	No	Are penalties for ethical transgressions publicly discussed?
Yes	No	Are there rewards for good ethical decisions even if they don't always result in a profit?
Yes	No	Does the company recognize the importance of creating a culture that is concerned about people and their investment in the business?
Yes	No	Does the company have a value system of fair play and honesty toward customers?
Yes	No	Do employees treat each other with respect, honesty, and fairness?
Yes	No	Do employees spend their time working in a cohesive way on what is valued by the organization?
Yes	No	Are there ethically based beliefs and values about how to succeed in the company?
Yes	No	Are there heroes or stars in the organization who communicate a common understanding about which positive ethical values are important?
Yes	No	Are there day-to-day rituals or behavior patterns that create direction and prevent confusion or mixed signals on ethics matters?
Yes	No	Is the firm more focused on the long run than on the short run?
Yes	No	Are employees satisfied or happy, and is employee turnover low?
Yes	No	Do the dress, speech, and physical aspects of the work setting contribute to a sense of consistency about what is right?
Yes	No	Are emotional outbursts about role conflict and ambiguity rare?
Yes	No	Has discrimination and/or sexual harassment been eliminated?
Yes	No	Is there an absence of open hostility and severe conflict?
Yes	No	Do people act on the job in a way that is consistent with what they say is ethical?
Yes	No	Is the firm more externally focused on customers, the environment, and the welfare of society than on its own profits?
Yes	No	Is there open communication between superiors and subordinates about ethical dilemmas?
Yes	No	Have employees ever received advice on how to improve ethical behavior or been disciplined for committing unethical acts?

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*Add up the number of "Yes" answers. The greater the number of "Yes" answers, the less likely ethical conflict is in your organization.

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have observed, “Employees will value and use as guidelines those activities for which they will be rewarded. When a behavior that is rewarded comes into conflict with an unstated and unmonitored ethical value, usually the rewarded behavior wins out.”[24]

Compliance versus Value-based Ethical Cultures

During the latter part of the twentieth century a distinction evolved between types of corporate cultures. The traditional ethics-based culture focused on compliance. The accounting professional model of rules created a **compliance culture** organized around risk. Compliance-based cultures use a legalistic approach to ethics. They use laws and regulatory rules to create codes and requirements. Codes of conduct are established with compliance as their focus, with rules and policies enforced by management. Instead of revolving around an ethical culture, the company revolves around risk management. The compliance approach is good in the short term because it helps management, stakeholders, and legal agencies to ensure that laws, rules, and the intent of compliance are fulfilled. A problem with the compliance approach, however, is its lack of long-term focus on values and integrity. In addition, it does not teach employees to navigate ethical gray areas.

Within the last 10 years there has been a shift from an approach focused on compliance to a values-based approach. A **values-based ethics culture** approach to ethical corporate cultures relies upon an explicit mission statement that defines the core values of the firm and how customers and employees should be treated. The board of directors as well as upper management might add to the general value statements by formulating more specific value statements for its strategic business units (SBU), which can be organized by product, geography, or function within the firm’s management structure. Certain areas may have rules that are associated with stated values, enabling employees to understand the relationship between the two. The focus of this type of corporate culture is on values such as trust, transparency, and respect to help employees identify and deal with ethical issues. It is important when using a values-based approach to explain why rules exist, what the penalties are if rules are violated, and how employees can help improve the ethics of the company. The crux of any ethical culture is top-down integrity with shared values, norms that provide guides for behavior, and visible artifacts such as codes of ethics that provide a standard of conduct. In developing a values-based ethical culture, a compliance element is also necessary because every organization has employees who will try to take advantage if the risk of being caught is low.

IKEA represents a values-based culture, with a mission “to create a better everyday life for the many.” The company maintains a strong commitment to best business practices, ethical behavior, and environmental initiatives. Not only does IKEA sell ecofriendly products and use alternative energy to power its stores, it also supports numerous causes such as Save the Children and American Forests. IKEA’s dedication to ethics and social responsibility has earned it a spot on *Ethisphere*’s 2010 list of the World’s Most Ethical Companies.[25]

Differential Association

Differential association refers to the idea that people learn ethical or unethical behavior while interacting with others who are part of their role-sets or who belong to other intimate personal groups.[26] The learning process is more likely to result in unethical behavior

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> **"The learning process is more likely to result in unethical behavior if the individual associates primarily with persons who behave unethically."**

if the individual associates primarily with persons who behave unethically. Associating with others who are unethical, combined with the opportunity to act unethically, is a major influence on ethical decision making, as described in the decision-making framework in Chapter 5.[27]

Consider a company in which salespeople incur travel expenses each week. When a new salesperson is hired, the other salespeople encourage the new employee to pad his or her expense accounts because there are some expenses that cannot be charged to the company. The new employee is shown how to pad the expense account and is told that failure to engage in this conduct will make others' expense reports look too high. In other words, the new employee is pressured to engage in misconduct.

A variety of studies have supported the notion that such differential association influences ethical decision making, and superiors in particular have a strong influence on the ethics of their subordinates. The actions of Mark Hernandez, who worked at NASA's Michoud Assembly Facility applying insulating foam to the space shuttles' external fuel tanks, provide an example of how coworker influence can produce tragic results. Within a few weeks on the job, coworkers taught him to repair scratches in the insulation without reporting the repairs. Supervisors encouraged the workers not to fill out the required paperwork on the repairs so that they could meet the space shuttle program's tight production schedules. After the shuttle *Columbia* broke up on reentry, killing all seven astronauts on board, investigators found that a piece of foam falling off a fuel tank during liftoff had irreparably damaged the shuttle.[28]

Several research studies have found that employees, especially young managers, tend to go along with their superiors' moral judgments to demonstrate loyalty. In one study, an experiment was conducted to determine how a hypothetical board of directors would respond to the marketing of one of its company's most profitable drugs, which resulted in 14 to 22 unnecessary deaths a year. When the imaginary board of directors learned that a competitor's drug was coming into the market with no side effects, more than 80 percent supported continuing to market the drug and taking legal and political action to prevent a ban. When asked their personal view on this situation, 97 percent believed that continuing to market the drug was irresponsible.[29] We have made it clear that *how* people typically make ethical decisions is not necessarily the way they *should* make ethical decisions. But we believe that you will be able to improve your own ethical decision making once you understand the potential influence of your interactions with others in your intimate work groups.

Whistle-Blowing

Interpersonal conflict occurs when employees think they know the right course of action in a situation, yet their work group or company promotes or requires a different, unethical decision. In such cases, employees may choose to follow their own values and refuse to participate in the unethical or illegal conduct. If they conclude that they cannot discuss what they are doing or what should be done with their coworkers or immediate supervisors, and if there is no method or protection for anonymous reporting, these employees may go outside the organization to publicize and correct the unethical situation, becoming whistle-blowers. A number of laws exist to protect whistle-blowers.

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Whistle-blowing means exposing an employer's wrongdoing to outsiders such as the media or government regulatory agencies. The term *whistle-blowing* is sometimes used to refer to internal reporting of misconduct to management, especially through anonymous reporting mechanisms, often called hotlines. Legal protection for whistle-blowers exists to encourage reporting of misconduct. Whistle-blower laws have provisions against retaliation and are enforced by a number of government agencies. For example, under the Sarbanes–Oxley Act, the U.S. Department of Labor (DOL) directly protects whistle-blowers who report violations of the law and refuse to engage in any action made unlawful. The Corporate and Criminal Fraud Accountability (CCFA) Act protects employees of publicly traded firms from retaliation if they report violations of any rule or regulation of the Securities and Exchange Commission, or any provision of federal law relating to fraud against shareholders. It also requires attorneys to become internal whistle-blowers as well.

The 2010 passage of the Dodd–Frank Act proposed additional incentives for whistle-blowers. Under the new rules, whistle-blowers who provide information that aids in the recovery of over $1 million could receive 10 to 30 percent of that amount. The belief is that monetary incentives will prompt observers of corporate misconduct to come forward, which could prevent future scandals like those leading up to the 2008–2009 financial crisis. One major concern with this new provision, however, is that it may cause whistle-blowers to go external with the information rather than internal. In other words, because of the potential for monetary rewards, whistle-blowers might be tempted to go straight to the Securities and Exchange Commission with their reports rather than first reporting the misconduct to the company's internal compliance officers.[30]

The Sarbanes–Oxley Act and the Federal Sentencing Guidelines for Organizations (FSGO) have institutionalized internal whistle-blowing to encourage discovery of organizational misconduct. For example, billionaire R. Allen Stanford's worst enemies may be former employees turned whistle-blowers who once worked for his company Stanford Financial Group. One lawsuit alleges that an employee hired to edit the firm's corporate magazine objected to and raised concerns about firm practices that he believed violated federal and state laws. He was later fired. Others who filed industry arbitration claims alleged that they were

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DEBATE ISSUE TAKE A STAND

Is Government Support for External Whistle-Blowing Effective?

A number of laws have been enacted to encourage members of organizations to report misconduct. While most firms support internal reporting of misconduct through anonymous hotlines, many organizations are concerned about employees going public or reporting misconduct to the government. Whistle-blowers are protected through the Sarbanes–Oxley Act and a number of other government agencies that deal with fraud, stock trading, and corrupt practices. In 2010 the Dodd–Frank Act gave additional incentives for whistle-blowers. Whistle-blowers are even encouraged to turn themselves in if they were part of a team or group that engaged in misconduct. Doing so could result in monetary rewards. Despite these incentives, whistle-blowers in general do not get good treatment and often have trouble finding employment after they have reported misconduct. It has also been found that companies with good internal reporting systems have fewer whistle-blowers that go external in an attempt to obtain rewards. This could be because employees feel that their concerns will be taken seriously and misconduct will be halted before it becomes a major problem.

1. Government support through financial incentives for reporting misconduct in organizations is effective and benefits society.
2. Government support of whistle-blowing should be redirected toward stronger incentives for internal reporting of misconduct, not external whistle-blowing that could be harmful to the individual.

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forced out of the fast-growing firm after questioning the ability of Stanford International Bank to justify high CD rates. In the Stanford case, whistle-blowers provided pivotal evidence documenting corporate malfeasance at a number of companies.[31] Yet historically, the fortunes of external whistle-blowers have not been positive; most were labeled traitors, and many lost their jobs. Even Sherron Watkins was a potential candidate for firing as the Enron investigation unfolded, with law firms assessing the implications of terminating her in light of her ethical and legal concerns about Enron.[32]

A study of 300 whistle-blowers by researchers at the University of Pennsylvania found that 69 percent lost their jobs or were forced to retire after exposing their companies' misdeeds.[33] For example, the whistle-blower who exposed Walmart chairman Thomas Coughlin for defrauding the company was terminated about a week after Coughlin resigned. Jared Bowen, a former vice president for Walmart Stores, Inc., claims that he was terminated for his exposure of Coughlin, in violation of a provision of the Sarbanes–Oxley Act protecting whistle-blowers.[34] If an employee provides information to the government about a company's wrongdoing, under the Federal False Claims Act the whistle-blower is known as a ***qui tam relator***. Upon investigation of the matter by the U.S. Department of Justice, the whistle-blower can receive between 15 and 25 percent of the recovered funds, depending upon how instrumental his or her claims were in holding the firm accountable for its wrongdoing.[35] Although most whistle-blowers do not receive positive recognition for pointing out corporate misconduct, some have turned to the courts and obtained substantial settlements. However, whistle-blowers have traditionally had a difficult time winning their cases. During the Clinton and Bush administrations, less than 5 percent of whistle blowers won settlements.[36]

To be truly effective, whistle-blowing requires that the individual have adequate knowledge of wrongdoing that could damage society. It is important to minimize risk to the whistle-blower while dealing with ethical issues.[37] Table 7.3 provides a checklist of questions an employee should ask before blowing the whistle externally. Figure 7.3 shows the types of retaliation whistle-blowers may face should they report misconduct. Although 15 percent of respondents to the National Business Ethics Survey indicated that they had experienced some form of retaliation after reporting misconduct, whistle-blowing had increased 5 percent from two years before.[38]

If whistle-blowers present an accurate picture of organizational misconduct, they should not fear for their jobs. Indeed, Sarbanes–Oxley and Dodd–Frank make it illegal

TABLE 7.3 Questions to Ask before Engaging in External Whistle-Blowing

1. Have I exhausted internal anonymous reporting opportunities within the organization?
2. Have I examined company policies and codes that outline acceptable behavior and violations of standards?
3. Is this a personal issue that should be resolved through other means?
4. Can I manage the stress that may result from exposing potential wrongdoing in the organization?
5. Can I deal with the consequences of resolving an ethical or legal conflict within the organization?

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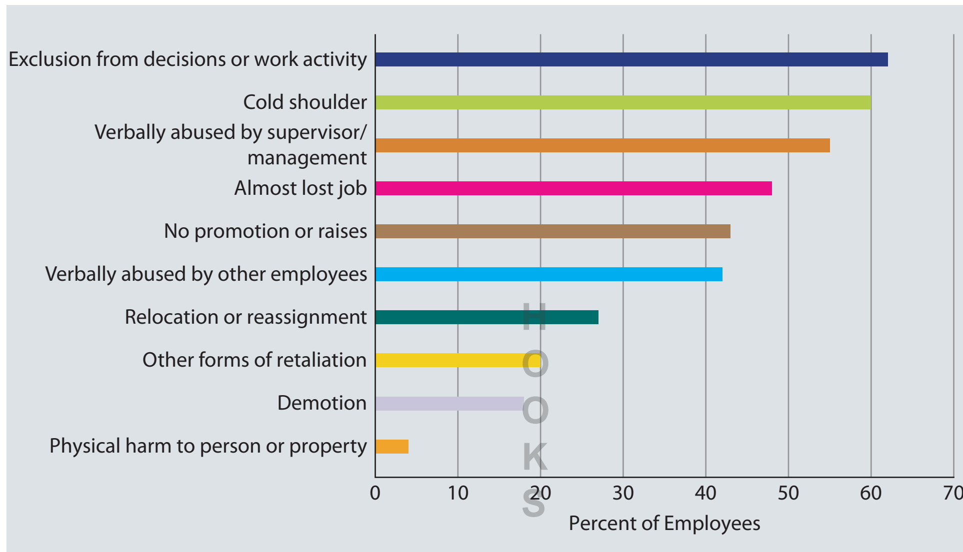
FIGURE 7.3 Forms of Retaliation Experienced as a Result of Reported Misconduct



Source: Ethics Resource Center, 2009 National Business Ethics Survey, p. 36.

to "discharge, demote, suspend, threaten, harass, or in any manner discriminate against" a whistle-blower and set penalties of up to 10 years in jail for executives who retaliate against whistle-blowers. The law also requires publicly traded companies to implement an anonymous reporting mechanism that allows employees to question actions that they believe may indicate fraud or other misconduct.[39] Additionally, the FSGO provides rewards for companies that systematically detect and address unethical or illegal activities. Within the federal stimulus funds, new whistle-blower protection was supported for state and local government employees and contractors, subcontractors, and grantees. The new law provides specific protections including the right to seek investigation and review by federal Inspectors General for "adverse actions" such as termination or demotions.[40]

Most public companies are setting up computer systems that encourage internal whistle-blowing. With over 5,500 employees, Marvin Windows (one of the world's largest custom manufacturers of wood windows and doors) wants employees to feel comfortable reporting violations of safety conditions, bad management, fraud, or theft. The system is anonymous and allows for reporting in employees' native languages. This system is used to alert management to potential problems in the organization and to facilitate investigations.[41]

Even before the passage of the Sarbanes–Oxley Act, an increasing number of companies were setting up anonymous reporting services, often through toll-free numbers, through which employees could report suspected violations or seek input on how to proceed when encountering ambiguous situations. These internal reporting services are perceived to be most effective when they are managed by an outside organization that specializes in maintaining ethics hotlines.

Figure 7.4 reveals that the majority of employees report misconduct to their immediate supervisors. However, the presence of hotlines and other mechanisms helps employees

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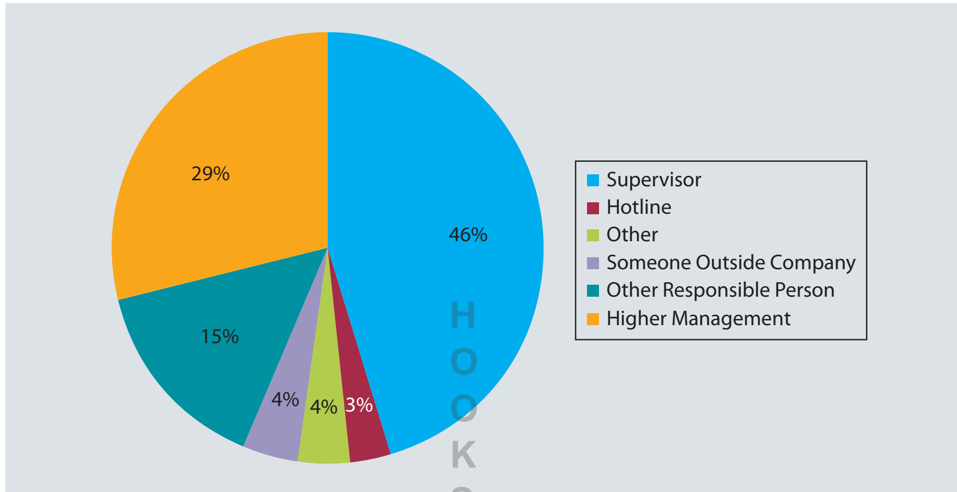
FIGURE 7.4 To Whom Do You Report Misconduct?



Source: Ethics Resource Center, Research Brief from the 2009 NBES, p. 15.

who feel uncomfortable reporting to their superiors. The results of a study show that three internal actions—confrontation, reporting to management, and calling the company ethics hotline—were positively correlated to several dimensions of an ethical culture. Conversely, inaction and external whistle-blowing were negatively correlated to several dimensions of an ethical culture. External whistle-blowing generally reflects a weakness in the ethical culture.[42] The extent to which employees feel that there will be no corrective action or that there will be retaliation as a result of their actions is a leading factor influencing their decisions not to report observed misconduct.

LEADERS INFLUENCE CORPORATE CULTURE

Organizational leaders can shape and influence corporate culture, resulting in ethical or unethical leadership. Leaders need to be both effective and ethical. An effective leader is one who does well for the stakeholders of the corporation. Effective leaders are good at getting followers to their common goals or objectives in the most effective and efficient way. Ken Lay and Jeffery Skilling were effective in that they transformed Enron from a small oil and gas pipeline firm into one of the largest entities in its industry. They were inspirational, imaginative, creative, and they motivated their personnel to achieve. But because their ethics were flawed they were not good for the company in the long term. According to Alan Yuspeh, Senior Vice President and Chief Ethics and Compliance Officer of Hospital Corporation of America (HCA), ethical companies and leadership should possess "aspirations that are higher than observing the law." The CEO of HCA and its board of directors have empowered Yuspeh to provide such leadership and supporting values to help employees appropriately respond to difficult ethical situations.[43] Consistency is also important for successful leaders.

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Power Shapes Corporate Culture

Power refers to the influence that leaders and managers have over the behavior and decisions of subordinates. An individual has power over others when his or her presence causes them to behave differently. Exerting power is one way to influence the ethical decision-making framework described in Chapter 5.

The status and power of leaders is directly correlated to the amount of pressure that they can exert on employees to get them to conform to their expectations. A superior can put strong pressure on employees, even when employees' personal ethical values conflict with the superior's wishes. For example, a manager might say to a subordinate, "I want the confidential information about our competitor's sales on my desk by Monday morning, and I don't care how you get it." A subordinate who values his or her job or who does not realize the ethical questions involved may feel pressure to do something unethical to obtain the data.

There are five power bases from which one person may influence another: (1) reward power, (2) coercive power, (3) legitimate power, (4) expert power, and (5) referent power.[44] These five bases of power can be used to motivate individuals either ethically or unethically.

REWARD POWER **Reward power** refers to a person's ability to influence the behavior of others by offering them something desirable. Typical rewards might be money, status, or promotion. Consider, for example, an auto salesperson who has two cars (a Toyota and a Kia) for sale. Let's assume that the Toyota is rated as higher quality than the Kia but is priced about the same. In the absence of any form of reward power, the salesperson would logically attempt to sell the Toyota. However, if the Kia had a higher commission, he would probably focus his efforts on selling the Kia. Such "carrot dangling" and incentives have been shown to be very effective in getting people to change their behavior in the long run. Therefore, rewards could encourage individuals to act in their own self-interest, not necessarily in the interest of stakeholders. In the short run, reward power is not as effective as coercive power.

COERCIVE POWER **Coercive power** is essentially the opposite of reward power. Instead of rewarding a person for doing something, coercive power penalizes actions or behavior. As an example, suppose a valuable client asks an industrial salesperson for a bribe and insinuates that he will take his business elsewhere if his demands are not met. Although the salesperson believes bribery is unethical, her boss has told her that she must keep the client happy or lose her chance at promotion. The boss is imposing a negative sanction if certain actions are not performed. Many companies have used a system whereby they systematically fire the lowest performing employees in their organization on an annual basis. Enron called it "rank and yank" and annually fired the lowest 20 percent. Motorola, Dow Chemical, and Microsoft have used similar systems for firing employees. Coercive power relies on fear to change behavior. For this reason, it has been found to be more effective in changing behavior in the short run than in the long run. Coercion is often employed in situations where there is an extreme imbalance of power. However, people who are continually subjected to coercion may seek a counterbalance by aligning themselves with other, more powerful persons or by simply leaving the organization. In firms that use coercive power, relationships usually break down in the long run. Power is an ethical issue not only for individuals but also for work groups that establish policy for large corporations.

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LEGITIMATE POWER **Legitimate power** stems from the belief that a certain person has the right to exert influence and that certain others have an obligation to accept it. The titles and positions of authority that organizations bestow on individuals appeal to this traditional view of power. Many people readily acquiesce to those who wield legitimate power, sometimes committing acts that are contrary to their beliefs and values. Betty Vinson, an accountant at WorldCom, objected to her supervisor's requests to produce improper accounting entries in an effort to conceal WorldCom's deteriorating financial condition. She finally gave in, however, accepting that this was the only way to save the company. She and other WorldCom accountants eventually pled guilty to conspiracy and fraud. She was sentenced to five months in prison and five months of house arrest.[45]

Such loyalty to authority figures can also be seen in corporations that have strong charismatic leaders and centralized structures. In business, if a superior tells an employee to increase sales "no matter what it takes" and that employee has a strong affiliation to legitimate power, the employee may try anything to fulfill that order. Dysfunctional leaders that are abusive and treat employees with contempt and disrespect can use legitimate power to pressure subordinates into unethical conduct. In these situations, employees may not voice their concerns or may use anonymous reporting systems to deal with the dysfunctional leader.[46]

EXPERT POWER **Expert power** is derived from a person's knowledge (or a perception that a person possesses knowledge). Expert power usually stems from a superior's credibility with subordinates. Credibility, and thus expert power, is positively correlated to the number of years that a person has worked in a firm or industry, the person's education, and the honors that he or she has received for performance. The perception that a person is an expert on a specific topic can also confer expert power on him or her. A relatively low-level secretary may have expert power because he or she knows specific details about how the business operates and can even make suggestions on how to inflate revenue through expense reimbursements.

Expert power may cause ethical problems when it is used to manipulate others or to gain an unfair advantage. Physicians, lawyers, and consultants can take unfair advantage of unknowing clients, for example. Accounting firms may gain extra income by ignoring concerns about the accuracy of financial data that they examine in an audit.

REFERENT POWER **Referent power** may exist when one person perceives that his or her goals or objectives are similar to another's. The second person may attempt to influence the first to take actions that will allow both to achieve their objectives. Because they share the same goals, the first person will perceive the other's use of referent power as beneficial. For this power relationship to be effective, however, some sort of empathy must exist between the individuals. Identification with others helps boost the decision maker's confidence, thus increasing his or her referent power.

Consider the following situation: Lisa Jones, a manager in the accounting department of a manufacturing firm, is being pressured to increase the rate at which sales are processed. She has asked Michael Wong, a salesperson, to speed up the delivery of sales contracts, and, if possible, to encourage advanced sales with delayed delivery. Michael protests that he does not want to push customers for future sales. Lisa therefore makes use of referent power. She invites Michael to lunch, and they discuss some of their work concerns, including the problem of increasing sales for accounting purposes. They agree that if document processing can be done through advanced sales, both will benefit. Lisa then suggests that

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Michael start sending sales contracts for the *next* quarter. He agrees to give it a try, and within several weeks the contracts are moving faster, and sales are increasing for the next quarter. Lisa's job is made easier, and Michael gets his commission checks a little sooner. On the other hand, this may be the beginning of what is called channel stuffing, or inflating the sales and income in the current quarter.

The five bases of power are not mutually exclusive. People typically use several power bases to effect change in others. Although power in itself is neither ethical nor unethical, its use can raise ethical issues. Sometimes a leader uses power to manipulate a situation or a person's values in a way that creates a conflict with the person's value structure. For example, a manager who forces an employee to choose between staying home with his sick child and keeping his job is using coercive power and creating a direct conflict with the employee's values. In business, titles and salary signify power, but power and wealth often breed arrogance and are easily abused.

MOTIVATING ETHICAL BEHAVIOR

A leader's ability to motivate subordinates plays a key role in maintaining an ethical organization. **Motivation** is a force within the individual that focuses his or her behavior toward achieving a goal. **Job performance** is considered to be a function of ability and motivation that can be represented by the equation (job performance = ability × motivation). This equation shows that employees can be motivated to accomplish things, but that resources and know-how are also needed to get a job done. To create motivation, an organization offers incentives that will encourage employees to work toward organizational objectives. Understanding motivation is important to effective management, and it also helps explain employees' ethical behavior. For example, a person who aspires to higher positions in an organization may sabotage a coworker's project to make that person look bad. This unethical behavior is directly related to the first employee's ambition (motivation) to rise in the organization. Employees want to feel that they are a good fit with their organization, have a clear understanding of job expectations, are supported in their role, and are valued and inspired to perform well. If an organization has shared values and an ethical culture, employees should be highly engaged and motivated because of their trust in others.

As businesspeople move into middle management and beyond, higher-order needs (social connections, esteem, and recognition) tend to become more important than lower-order needs (salary, safety, and job security). Research has shown that an individual's career stage, age, organization size, and geographic location affect the relative priority that he or she gives to satisfying respect, self-esteem, and basic physiological needs. An individual's hierarchy of needs may influence his or her motivation and ethical behavior. After basic needs such as food, working conditions (existence needs), and survival are satisfied, relatedness needs and growth needs become important. **Relatedness needs** are satisfied by social and interpersonal relationships, and **growth needs** are satisfied by creative or productive activities.[47]

From an ethics perspective, needs or goals may change as a person progresses through the ranks of the company. This shift may cause or help to solve problems depending on the person's current ethical status relative to the company or society. For example, junior executives might inflate purchase or sales orders, overbill time worked on projects, or accept cash gratuities if they are worried about providing for their families' basic physical

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necessities. As they continue up the ladder and are able to fulfill these needs, such concerns may become less important. Consequently, these managers may go back to obeying company policy or conforming to organizational culture and be more concerned with internal recognition and achievement than their families' physical needs. Younger employees tend to rely on organizational culture for guidance, but older employees have been found to improve ethical performance.

Examining the role that motivation plays in ethics offers a way to relate business ethics to the broader social context in which workers live and the deeper moral assumptions on which society depends. Workers are individuals, and they will be motivated by a variety of personal interests. Although we keep emphasizing that managers are positioned to exert pressure and force individuals' compliance on ethically related issues, we also acknowledge that an individual's personal ethics and needs will significantly affect his or her ethical decisions.

ORGANIZATIONAL STRUCTURE AND BUSINESS ETHICS

An organization's structure is important to the study of business ethics because the various roles and job descriptions that comprise that structure may create opportunities for unethical behavior. The structure of organizations can be described in many ways. For simplicity's sake, we will discuss two broad categories of organizational structures—centralized and decentralized. Note that these are not mutually exclusive structures; in the real world, organizational structures exist on a continuum. Table 7.4 compares some strengths and weaknesses of centralized and decentralized structures.

In a **centralized organization,** decision-making authority is concentrated in the hands of top-level managers, and little authority is delegated to lower levels. Responsibility, both internal and external, rests with top-level managers. This structure is especially suited to organizations that make high-risk decisions and whose lower-level managers are not highly skilled in decision making. It is also suitable for organizations in which production processes are routine and efficiency is of primary importance. These organizations are usually extremely bureaucratic, and the division of labor is typically very well defined. Each worker knows his or her job and what is specifically expected, and each has a clear understanding of how to carry out assigned tasks. Centralized organizations stress formal rules, policies, and procedures, which are backed up with elaborate control systems. Their codes of ethics may specify the techniques to be used for decision making. General Motors, the Internal Revenue Service, and the U.S. Army are examples of centralized organizations.

Because of their top-down approach and the distance between managers and the decision maker, centralized organizational structures can lead to unethical acts. If formal rules and policies are unfairly executed, they lose their validity or efficacy. To some extent, rules can be deactivated even if they are formally still in force.[48] If the centralized organization is very bureaucratic, some employees may behave according to the letter of the law rather than the spirit. For example, a centralized organization can have a policy about bribes that does not include wording about donating to a client's favorite charity before or after a sale. Such donations or gifts can, in some cases, be construed as a tacit bribe because the employee buyer could be swayed by the donation, or gift, to act in a less than favorable way or not to act in the best interests of his or her firm.

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TABLE 7.4 Structural Comparison of Organizational Types

	Emphasis	
Characteristic	**Centralized**	**Decentralized**
Hierarchy of authority	Centralized	Decentralized
Flexibility	Low	High
Adaptability	Low	High
Problem recognition	Low	High
Implementation	High	Low
Dealing with changes	Poor environmental complexity	Good
Rules and procedures	Many and formal	Few and informal
Division of labor	Clearcut	Ambiguous
Span of control	Many employees	Few employees
Use of managerial techniques	Extensive	Minimal
Coordination and control	Formal and impersonal	Informal and personal

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Other ethical concerns may arise in centralized structures because they typically have very little upward communication. Top-level managers may not be aware of problems and unethical activity. Some companies' use of sweatshop labor may be one manifestation of this lack of upward communication. Sweatshops produce products such as garments by employing laborers, sometimes through forced immigrant labor, who often work 12- to 16-hour shifts for little or no pay. The UN International Labor Office says that forced labor costs approximately $21 billion a year in the form of children enslaved in sweatshops, migrant laborers working on farms and building homes, illegal immigrants subservient to their smugglers, and other forms of coercion. Asia is home to nearly three-quarters of all forced workers in the world. Industries that benefit the most from the cheap labor they provide include electronics, automobiles, textiles, construction, fishing, and agriculture.[49] Another ethical issue that may arise in centralized organizations is blame shifting, or scapegoating. People may try to transfer blame for their actions to others who are not responsible. The specialization and rigid division of labor in centralized organizations can also create ethical problems. Employees may not understand how their actions can affect the overall organization because they work with only one piece of a much larger puzzle. This lack of connectedness can lead employees to engage in unethical behavior because they fail to understand the overall ramifications of their behavior.

In a **decentralized organization,** decision-making authority is delegated as far down the chain of command as possible. Such organizations have relatively few formal rules, and coordination and control are usually informal and personal. They focus instead on increasing the flow of information. As a result, one of the main strengths of decentralized organizations is their adaptability and early recognition of external change. With greater flexibility, managers can react quickly to changes in their ethical environment. Google is known for being decentralized and for empowering its employees. A parallel weakness of

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TABLE 7.5 Examples of Centralized and Decentralized Corporate Cultures

Company	Organizational Culture	Characterized by
Nike	Decentralized	Creativity, freedom, informality
Southwest Airlines	Decentralized	Fun, teamwork orientation, loyalty
General Motors	Centralized	Unions, adherence to task assignments, structured
Microsoft	Decentralized	Creative, investigative, fast paced
Procter & Gamble	Centralized	Experienced, dependable, a rich history and tradition of products, powerful

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decentralized organizations is the difficulty they have in responding quickly to changes in policy and procedures established by top management. In addition, independent profit centers within a decentralized organization may deviate from organizational objectives. Decentralized firms may have fewer internal controls and use shared values for their ethical standards. If a firm depends on abstract values without specific rules of conduct, there may be more variation in behavior. Also, it may be harder to control rogue employees who engage in misconduct. Table 7.5 gives examples of centralized versus decentralized organizations and describes their different corporate cultures.

Due to the strict formalization and implementation of ethics policies and procedures in centralized organizations, they tend to be more ethical in their practices than decentralized organizations. Centralized organizations may also exert more influence on their employees because they have a central core of policies and codes of ethical conduct. Decentralized organizations give employees extensive decision-making autonomy because management empowers the employees. Ambiguity in the letter versus the spirit of rules can create ethical challenges, especially for newer managers.[50] However, it is also true that decentralized organizations may be able to avoid ethical dilemmas through the use of effective codes of conduct and ethics. If widely shared values and effective ethics programs are in place in decentralized organizations, there may be less need for excessive compliance systems. However, different units in the company may evolve with diverse value systems and approaches to ethical decision making. For example, a high-tech defense firm like Lockheed Martin, which employs more than 200,000 people, might have to cope with many different decisions on the same ethical issue if it did not have a centralized ethics program. Boeing has become more centralized since the entrance of CEO W. James McNerney, Jr., and the exit of previous CEO Harry Stonecipher, who carried on a relationship with a female vice president of the company. Before McNerney stepped in, Boeing had gone through several years of ethics and legal difficulties, including the jailing of the former CFO for illegal job negotiations with Pentagon officials, indictment of a manager for stealing 25,000 pages of proprietary documents, abuse of attorney-client privilege to cover up internal studies showing pay inequities, and other scandals.[51]

Unethical behavior is possible in either centralized or decentralized structures when specific corporate cultures permit or encourage workers to deviate from accepted standards or ignore corporate legal and ethical responsibilities. Centralized firms may have a more difficult time uprooting unethical activity than decentralized organizations as the latter has a more fluid structure in which changes may affect only a small portion of the

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company. Often, when a centralized firm uncovers unethical activity and it appears to be pervasive, the leadership is removed so that the old unethical culture can be uprooted and replaced with a more ethical one. For example, Mitsubishi Motors suggested significant management changes after it was discovered that a cover-up of auto defects had been going on for more than two decades.

GROUP DIMENSIONS OF CORPORATE STRUCTURE AND CULTURE

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When discussing corporate culture, we tend to focus on the organization as a whole. But corporate values, beliefs, patterns, and rules are often expressed through smaller groups within the organization. Moreover, individual groups within organizations often adopt their own rules and values.

Types of Groups

Two main categories of groups affect ethical behavior in business. A **formal group** is defined as an assembly of individuals with an organized structure that is explicitly accepted by the group. An **informal group** is defined as two or more individuals with a common interest but without an explicit organizational structure.

FORMAL GROUPS Formal groups can be divided into committees, work groups, and teams.

Committees, Work Groups, and Teams A *committee* is a formal group of individuals assigned to a specific task. Often a single manager could not complete the task, or management may believe that a committee can better represent different constituencies and improve the coordination and implementation of decisions. Committees may meet regularly to review performance, develop plans, or make decisions. Most formal committees in organizations operate on an ongoing basis, but their membership may change over time. A committee is an excellent example of a situation in which coworkers and significant others within the organization can influence ethical decisions. Committee decisions are legitimized in part by agreement or majority rule. In this respect, minority views on issues such as ethics can be pushed aside through the majority's authority. Committees bring diverse personal moral values to the ethical decision-making process, which may expand the number of alternatives considered. Also inherent in the committee structure is a lack of individual responsibility. Because of the diverse composition of the group, members may not be committed or willing to assume responsibility for the group decision. Groupthink may emerge, enabling the majority to explain ethical considerations away.

Although many organizations have financial, diversity, personnel, or social responsibility committees, only a very few organizations have committees that are devoted exclusively to ethics. An ethics committee might raise ethical concerns, resolve ethical dilemmas in the organization, and create or update the company's code of ethics. Motorola, for example, maintains a Business Ethics Compliance Committee that interprets, classifies, communicates, and enforces the company's code and ethics initiatives. An ethics committee can gather information on functional areas of the business and examine manufacturing

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practices, personnel policies, dealings with suppliers, financial reporting, and sales techniques to find out whether the company's practices are ethical. Though much of a corporation's culture operates informally, an ethics committee is an example of a highly formalized approach for dealing with ethical issues.

Work groups are used to subdivide duties within specific functional areas of a company. For example, on an automotive assembly line, one work group might install the seats and interior design elements of the vehicle while another group installs all the dashboard instruments. This enables production supervisors to specialize in a specific area and provide expert advice to work groups.

While work groups operate within a single functional area, *teams* bring together the expertise of employees from several different areas of the organization—for example, finance, marketing, and production—on a single project, such as developing a new product. Many manufacturing firms, including General Motors, Westinghouse, and Procter & Gamble, are using the team concept to improve participative management. Ethical conflicts may arise because team members come from different functional areas. Each member of the team has a particular role to play and has probably had limited interaction with other members of the team. Conflicts often occur when members of different organizational groups must interact. However, airing viewpoints representative of all the functional areas helps provide more options from which to choose.

Work groups and teams provide the organizational structure for group decision making. One of the reasons why individuals cannot implement only their own personal ethical beliefs in organizations is that work groups collectively reach so many decisions. However, those who have legitimate power are in a position to influence ethics-related activities. The work group and team often sanction certain activities as ethical or define others as unethical.

INFORMAL GROUPS In addition to the groups that businesses formally organize and recognize—such as committees, work groups, and teams—most organizations contain a number of informal groups. These groups are usually composed of individuals, often from the same department, who have similar interests and band together for companionship or for purposes that may or may not be relevant to the goals of the organization. For example, four or five people who have similar tastes in outdoor activities and music may discuss their interests while working, and they may meet outside work for dinner, concerts, sports events, or other activities. Other informal groups may evolve to form a union, improve working conditions or benefits, get a manager fired, or protest work practices that they view as unfair. Informal groups may generate disagreement and conflict, or they may enhance morale and job satisfaction.

> **"Informal groups help develop informal channels of communication, sometimes called the "grapevine," which are important in every organization."**

Informal groups help develop informal channels of communication, sometimes called the grapevine, which are important in every organization. Informal communication flows up, down, diagonally, and horizontally, not necessarily following the communication lines on a company's organizational chart. Information passed along the grapevine may relate to the job, the organization, or an ethical issue, or it may simply be gossip and rumors. The grapevine can act as an early warning system for employees. If employees learn informally that their company may be sold or that a particular action will be condemned as unethical by top management or the community, they have

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time to think about how they will respond. Because gossip is not uncommon in an organization, the information passed along the grapevine is not always accurate, but managers who understand how the grapevine works can use it to reinforce acceptable values and beliefs.

The grapevine is also an important source of information for individuals to assess ethical behavior within their organization. One way an employee can determine acceptable behavior is to ask friends and peers in informal groups about the consequences of certain actions such as lying to a customer about a product-safety issue. The corporate culture may provide employees with a general understanding of the patterns and rules that govern behavior, but informal groups make this culture come alive and provide direction for employees' daily choices. For example, if a new employee learns anecdotally through the grapevine that the organization does not punish ethical violations, he or she may seize the next opportunity for unethical behavior if it accomplishes the organization's objectives. There is a general tendency to discipline top sales performers more leniently than poor sales performers for engaging in identical forms of unethical selling behavior. A superior sales record appears to induce more lenient forms of discipline, despite organizational policies that state otherwise.[52] In this case, the grapevine has clearly communicated that the organization rewards those who break the ethical rules to achieve desirable objectives.

Group Norms

Group norms are standards of behavior that groups expect of their members. Just as corporate culture establishes behavior guidelines for an organization's members, group norms help define acceptable and unacceptable behavior within a group. In particular, group norms define the limit allowed on deviations from group expectations.

Most work organizations, for example, develop norms that govern groups' rates of production and communication with management as well as provide a general understanding of behavior considered right or wrong, ethical or unethical, within the group. For example, other group members may punish an employee who reports to a supervisor that a coworker has covered up a serious production error. Other members of the group may glare at the informant, who has violated a group norm, and refuse to talk to or sit next to him or her.

Norms have the power to enforce a strong degree of conformity among group members. At the same time, norms define the different roles for various positions within the organization. For example, a low-ranking member of a group may be expected to carry out an unpleasant task such as accepting responsibility for someone else's ethical mistake. Abusive behavior toward new or lower-ranking employees could be a norm in an informal group.

Sometimes group norms conflict with the values and rules prescribed by the organization's culture. For example, the organization may have policies prohibiting the use of personal social networking sites during work hours and may use rewards and punishments to encourage this culture. In a particular informal group, however, norms may encourage using personal social networking sites during work hours and avoiding management's attention. Issues of equity may arise in this situation if other groups believe they are unfairly forced to follow policies that are not enforced. These other employees may complain to management or to the offending group. If they believe management is not taking corrective action they, too, may begin to use social networking for personal use, thus hurting the whole organization's productivity. For this reason, management must carefully monitor not only the corporate culture but also the norms of all the various groups within the organization. Sanctions may be necessary to bring in line a group whose norms deviate sharply from the overall culture.

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VARIATION IN EMPLOYEE CONDUCT

Although a corporation is required to take responsibility for conducting its business ethically, a substantial amount of research indicates that significant differences exist in individual employees' values and philosophies and therefore in how they deal with ethical issues.[53] In other words, because people are culturally diverse and have different values, they interpret situations differently and the ethical decisions they make on the same ethical issue will vary.

Table 7.6 shows that approximately 10 percent of employees take advantage of situations to further their own personal interests. These individuals are more likely to manipulate, cheat, or act in a self-serving manner when the benefits to be gained from doing so are greater than the penalties for the misconduct. Such employees may choose to take office supplies from work for personal use if the only penalty they will suffer if caught is having to pay for the supplies. The lower the risk of being caught is, the higher the likelihood that the 10 percent most likely to take advantage of the company will be involved in unethical activities.

Another 40 percent of workers go along with the work group on most matters. These employees are most concerned about the social implications of their actions and want to fit into the organization. Although they have their own personal opinions, they are easily influenced by what the people around them are doing. These individuals may know that using office supplies for personal use is improper, yet they view it as acceptable because their coworkers do so. These employees rationalize their actions by saying that the use of office supplies is one of the benefits of working at their particular company, and it must be acceptable because the company does not enforce a policy prohibiting the behavior. Coupled with this philosophy is the belief that no one will get into trouble for doing what everybody else is doing.

About 40 percent of a company's employees, as shown in Table 7.6, always try to follow company policies and rules. These workers not only have a strong grasp of their corporate culture's definition of acceptable behavior, but also attempt to comply with codes of ethics, ethics training, and other communications about appropriate conduct. If the company has a policy prohibiting taking office supplies from work, these employees probably will observe it. However, they are not likely to speak out about the 40 percent who choose to go along with the work group, for these employees prefer to focus on their jobs and steer clear of any organizational misconduct. If the company fails to communicate standards of appropriate behavior, members of this group will devise their own.

The final 10 percent of employees try to maintain formal ethical standards that focus on rights, duties, and rules. They embrace values that assert certain inalienable rights

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TABLE 7.6 Variation in Employee Conduct*

10%	40%	40%	10%
Follow their own values and beliefs; believe that their values are superior to those of others in the company	Always try to follow company policies	Go along with the work group	Take advantage of situations if the penalty is less than the benefit and the risk of being caught is low

*With kind permission from Springer Science+Business Media: Journal of the Academy of Marketing Science, "Cognitive Consistency of Marketing Managers in Ethical Situations," 20(3), January 1, 1992, pp. 243–252, John Fraedrich and O.C. Ferrell.

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and actions, which they perceive to be always ethically correct. In general, members of this group believe that their values are right and superior to the values of others in the company, or even to the company's value system, when an ethical conflict arises. These individuals have a tendency to report the misconduct of others or to speak out when they view activities within the company as unethical. Consequently, members of this group will probably report colleagues who take office supplies.

The significance of this variation in the way individuals behave ethically is simply the fact that employees use different approaches when making ethical decisions. Because of the probability that a large percentage of any work group will either take advantage of a situation or at least go along with the work group, it is vital that companies provide communication and control mechanisms to maintain an ethical culture. Companies that fail to monitor activities and to enforce ethics policies provide a low-risk environment for those employees who are inclined to take advantage of situations to accomplish their personal, and sometimes unethical, objectives.

Good business practices and concern for the law require organizations to recognize this variation in employees' desire to be ethical. The percentages cited in Table 7.6 are only estimates, and the actual percentages of each type of employee may vary widely across organizations based on individuals and corporate culture. The specific percentages are less important than the fact that our research has identified these variations as existing within most organizations. Organizations should focus particular attention on managers who oversee the day-to-day operations of employees within the company. They should also provide training and communication to ensure that the business operates ethically, that it does not become the victim of fraud or theft, and that employees, customers, and other stakeholders are not abused through the misconduct of people who have a pattern of unethical behavior.

As we have seen throughout this book, many examples can be cited of employees and managers who have no concern for ethical conduct but who are nonetheless hired and placed in positions of trust. Some corporations continue to support executives who ignore environmental concerns, poor working conditions, or defective products, or who engage in accounting fraud. Executives who can get results, meaning profits, regardless of the consequences, are often admired and lauded, especially in the business press. When their unethical or even illegal actions become public knowledge, however, they risk more than the loss of their positions. Table 7.7 summarizes the penalties that corporate executives have experienced over the past several years.

CAN PEOPLE CONTROL THEIR OWN ACTIONS WITHIN A CORPORATE CULTURE?

Many people find it hard to believe that an organization's culture can exert so strong an influence on individuals' behavior within the organization. In our society, we want to believe that individuals control their own destinies. A popular way of viewing business ethics is therefore to see it as a reflection of the alternative moral philosophies that individuals use to resolve their personal moral dilemmas. As this chapter has shown, however, ethical decisions within organizations are often made by committees and formal and informal groups, not by individuals. Decisions related to financial reporting, advertising, product design, sales practices, and pollution-control issues are often beyond the influence of

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TABLE 7.7 Penalties for Convictions of Organizational Wrongdoing

Executive/Company	Trial Outcome
Franklin Brown, former general counsel, Rite Aid	Convicted and sentenced to 10 years in prison
Bernard Ebbers, former chairman and CEO, WorldCom	Convicted and sentenced to 25 years to life in prison
Dennis Kozlowski, former CEO, Tyco	Mistrial in first trial; in second, convicted and sentenced to 8 1⁄3 to 25 years in prison
Jeffery Skilling, former president of Enron	Convicted of multiple felony charges and currently serving a 24-year, 4-month prison sentence
Joseph P. Nacchio, former CEO of Qwest Communications International	Convicted of insider trading, $19 million fine, forfeit of $52 million, and 6 years in prison
Xujia Wang, vice president of finance, Morgan Stanley Company	Convicted of securities fraud and conspiracy to commit securities fraud, 18 months in prison and $611,248 fine
Attorney Raymond Joseph Costanzo, Jr.	Provided false qualifying information and falsified down payments, 3 years, 5 months in prison to be followed by 4 years of supervised release and ordered to pay $7,843,184 in restitution
Gandhi Ben Morka, real estate appraiser	Convicted of mortgage fraud, 60 months in prison, and ordered to pay more than $2.3 million in restitution
Bernard Madoff, stockbroker and founder of Bernard L. Madoff Investment Securities LLC	Convicted of operating $65 billion Ponzi scheme, sentenced to 150 years in prison

Source: From *The Wall Street Journal* online, "White-Collar Defendants: Take the Stand, or Not?," April 2, 2006; FBI Report, http://www.fbi.gov/publications/financial/fcs_report2007/financial_crime_2007.htm (accessed August 19, 2009); "Bernard L. Madoff," *The New York Times,* http://topics.nytimes.com/top/reference/timestopics/people/m/bernard_l_madoff/index.html (accessed March 8, 2011).

individuals alone. In addition, these decisions are frequently based on business rather than personal goals.

Most new employees in highly bureaucratic organizations have limited input into the basic operating rules and procedures for getting things done. Along with learning sales tactics and accounting procedures, employees may be taught to ignore a design flaw in a product that could be dangerous to users. Although many personal ethics issues may seem straightforward and easy to resolve, individuals entering business will usually need several years of experience within a specific industry to understand how to resolve ethical close calls. Both individual ethics and organizational ethics have an impact on an employee's ethical intention. If there is congruence between individual ethics and the organizational ethical culture, there is an increase in the potential for making ethical choices in organizational decision-making. Younger managers may need more support and guidance from the organization because of their limited experience in dealing with complex issues.[54] Research has also indicated that congruence between individual and organizational values is greater in the private sector. On the other hand, age and organizational type aside, personal values appear to be a strong factor in decreasing unethical practices and increasing appropriate work behavior as compared to congruence in personal and organizational values.[55]

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It is not our purpose to suggest that you ought to go along with management or the group on business ethics issues. Honesty and open discussions of ethical issues are important to successful ethical decision making. We believe that most companies and businesspeople try to make ethical decisions. However, because there is so much difference among individuals, ethical conflict is inevitable. If you manage and supervise others, it will be necessary to maintain ethical policies for your organization and report misconduct that occurs. Ethics is not just a personal matter.

Regardless of how a person or organization views the acceptability of a particular activity, if society judges it to be wrong or unethical, then this larger view directly affects the organization's ability to achieve its goals. Not all activities deemed unethical by society are illegal. But if public opinion decries or consumers protest against a particular activity, the result may be legislation that restricts or bans a specific business practice. For instance, concern about promoting unhealthy products to children has prompted some governments to take action. Santa Clara County in California and the San Francisco, California, Board of Supervisors banned toys in fast food offerings such as Happy Meals that do not meet certain nutritional standards. Restaurants were given until the end of 2011 to ensure that their food offerings contained fewer than 600 calories if they still want to offer toys with the meals. Proponents see this as a step in the right direction, as they believe that the toys basically sell the meals—in other words, children convince their parents to buy unhealthy meals simply to obtain the toy. Opponents argue that the city is taking it upon itself to discourage children from wanting to eat at McDonald's—thereby trying to protect them from obesity—when in fact that duty belongs to the parents. McDonald's restaurants affected by the ban feel they are being unfairly targeted because of their size and fear that the ban could harm business.[56] Sometimes businesses themselves will take action in order to prevent future government regulation that could limit their activities. For instance, Coca-Cola, Cadbury Schweppes, and PepsiCo all voluntarily agreed to stop selling soda in schools.[57]

If a person believes that his or her personal ethics severely conflict with the ethics of the work group and those of superiors in an organization, that person's only alternative may be to leave the organization. In the highly competitive employment market of the twenty-first century, quitting a job because of an ethical conflict requires courage and, possibly, the ability to survive without a job. Obviously, there are no easy answers for resolving ethical conflicts between the organization and the individual. Our goal is not to tell you what you should do. But we do believe that the more you know about how ethical decision making occurs within organizations, the more opportunity you will have to influence decisions positively and help resolve ethical conflicts more effectively.

SUMMARY

Corporate culture refers to the set of values, beliefs, goals, norms, and ways of solving problems that the members (employees) of an organization share. These shared values may be formally expressed or unspoken. Corporate cultures can be classified in several ways, and a cultural audit can identify an organization's culture. If an organization's culture rewards unethical behavior, people within the company are more likely to act unethically. A company's failure to monitor or manage its culture may foster questionable behavior.

Leadership—the ability or authority to guide others toward achieving goals—has a significant impact on the ethical decision-making process because leaders have the power to

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motivate others and enforce both the organization's rules and policies and their own viewpoints. A leader must not only gain the respect of his or her followers but must also provide a standard of ethical conduct. Leaders exert power to influence the behaviors and decisions of subordinates. There are five power bases from which a leader may influence ethical behavior: reward power, coercive power, legitimate power, expert power, and referent power. Leaders also attempt to motivate subordinates; motivation is an internal force that focuses an individual's behavior toward achieving a goal. It can be created by the incentives that an organization offers employees.

The structure of an organization may create opportunities to engage in unethical behavior. In a centralized organization, decision-making authority is concentrated in the hands of top managers, and little authority is delegated to lower levels. In a decentralized organization, decision-making authority is delegated as far down the chain of command as possible. Centralized organizations tend to be more ethical than decentralized ones because they enforce more rigid controls, such as codes of ethics and corporate policies, on ethical practices. However, unethical conduct can occur in both types of structures.

In addition to the values and customs that represent the culture of an organization, individual groups within the organization often adopt their own rules and values and even create subcultures. The main types of groups are formal groups—which include committees, work groups, and teams—and informal groups. Informal groups often feed an informal channel of communication called the grapevine. Group norms are standards of behavior that groups expect of their members. They help define acceptable and unacceptable behavior within a group and especially define the limits on deviating from group expectations. Sometimes group norms conflict with the values and rules prescribed by the organization's culture.

Sometimes an employee's own personal ethical standards conflict with what is expected of him or her as a member of an organization and its corporate culture. This is especially true given that an organization's ethical decisions are often resolved by committees, formal groups, and informal groups rather than by individuals. When such ethical conflict is severe, the individual may have to decide whether to leave the organization.

IMPORTANT TERMS FOR REVIEW

Sarbanes–Oxley 404
apathetic culture
caring culture
exacting culture
integrative culture
cultural audit
compliance culture
values-based ethics culture
differential association
whistle-blowing
qui tam relator
reward power
coercive power
legitimate power
expert power
referent power
motivation
job performance
relatedness needs
growth needs
centralized organization
decentralized organization
formal group
informal group
group norm

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RESOLVING ETHICAL BUSINESS CHALLENGES*

As Gerard sat down in his expensive new chair, he felt worried. What had he gotten himself into? How could things have gone so wrong so fast? It was as if he'd been walking along and a truck had blindsided him. Gerard had been with Trawlers Accounting, a medium-sized firm, for several years. His wife, Vicky, had a job in the pharmaceutical industry, and their first child was due any day now. The doctor had told her that she would need to stop work early because hers was a high-risk pregnancy. So three months before her due date, she asked for and received a four-month leave of absence. This was great, but the leave was without pay. Luckily, Gerard had received a promotion and now headed a department.

Some interesting changes were occurring in the accounting industry. For example, Gerard's superior had decided that all CPAs would take exams to become registered investment advisers. The rationale for such a new development was simple. The firm could use its relationships with clients to increase investment revenues. Because of the long-term nature of these relationships with many firms and individuals as well as the implicit sense of honesty that CPAs must bring to their jobs, clients understood that a violation of so high a trust was unlikely—or so Gerard's boss argued. Many of the people in Gerard's department didn't like this new policy; however, some who had passed the exams had increased their pay by 15 percent. During lunch, one of Gerard's financial friends engaged him heatedly.

"What you're doing, Gerard, is called unfair competition," the friend accused him. "Your CPAs have exclusive access to confidential client taxpayer information, which could give you insight into people's financial needs. Besides, you could easily direct clients to mutual funds that you already own in order to keep your own personal investments afloat. Also, if your people start chasing commissions and fees on mutual funds that go bad, your credibility will become suspect, and no one will trust you again. Plus, your people will now have to keep abreast of financial, tax, and accounting changes."

When Gerard got to his office, he found that some of his people had been recommending a group of mutual funds that Trawlers had been auditing. Then someone from another of his company's accounting clients, CENA Mutual Funds, telephoned.

"What's the idea of having your people suggest PPI Mutual Funds when they are in direct competition with us?" the caller yelled. "We pay you a lot to do our accounting procedures, and that's how you reward us? I want to know by the end of the day if you are going to continue to push our competitor's product. I don't have to tell you that this will directly affect your department and you. Also, things like this get around the business circles, if you know what I mean."

With these words, the caller hung up on Gerard.

QUESTIONS | EXERCISES

1. Identify the ethical and legal issues of which Gerard needs to be aware.
2. Discuss the advantages and disadvantages of each decision Gerard has made and could make.
3. Discuss the issue of accounting firms going into the financial services market.
4. Discuss the types of groups that are influencing Gerard.

*This case is strictly hypothetical; any resemblance to real persons, companies, or situations is coincidental.

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CHECK YOUR EQ

Check your EQ, or Ethics Quotient, by completing the following. Assess your performance to evaluate your overall understanding of the chapter material.

1. Decentralized organizations tend to put the blame for unethical behavior on lower-level personnel. **Yes** **No**
2. Decentralized organizations give employees extensive decision-making autonomy. **Yes** **No**
3. Corporate culture provides rules that govern behavior within the organization. **Yes** **No**
4. An integrative culture shows high concern for performance and little concern for people. **Yes** **No**
5. Coercive power works in the same manner as reward power. **Yes** **No**

ANSWERS **1. No.** This is more likely to occur in centralized organizations. **2. Yes.** This is known as empowerment. **3. Yes.** Values, beliefs, customs, and ceremonies represent what is acceptable and unacceptable in the organization. **4. No.** This describes an exacting culture. An integrative culture combines a high concern for people with a high concern for production. **5. No.** Coercive power is the opposite of reward power. One offers rewards and the other responds with punishment to encourage appropriate behavior.

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CHAPTER 8

DEVELOPING AN EFFECTIVE ETHICS PROGRAM

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CHAPTER OBJECTIVES

- To understand the responsibility of the corporation to be a moral agent
- To understand why businesses need to develop ethics programs
- To list the minimum requirements for an ethics program
- To describe the role of codes of ethics in identifying key risk areas for an organization
- To identify the keys to successful ethics training, including program types and goals
- To examine the ways that ethical standards are monitored, audited, and enforced, and to understand the need for continuous improvement

CHAPTER OUTLINE

The Responsibility of the Corporation as a Moral Agent

The Need for Organizational Ethics Programs

An Effective Ethics Program

An Ethics Program Can Help Avoid Legal Problems

Values versus Compliance Programs

Codes of Conduct

Ethics Officers

Ethics Training and Communication

Systems to Monitor and Enforce Ethical Standards

Continuous Improvement of an Ethics Program

Common Mistakes in Designing and Implementing an Ethics Program

AN ETHICAL DILEMMA*

Victoria was starting to wonder about her company's strategy as well as about the implications of her own actions. She had begun working for Koke International (KI) after graduating from Pacific West University with degrees in both finance and marketing. KI was the leader in franchised home repair outlets in the United States. In 25 years, KI had grown from several stores in the Pacific Northwest to 250 stores located across the United States and Canada. Koke International came to dominate the markets that it entered by undercutting local competitors on price and quality. The lower prices were easy to charge because KI received large quantity discounts from its vendors. The franchise concept also helped create another barrier to entry for KI's competitors. By expanding rapidly, KI was able to spread the costs of marketing to many more stores, giving it still another differential advantage. This active nourishment of its brand image coupled with some technological advances such as just-in-time inventory and electronic scanners had sent KI's stock soaring. As a result, it had a 50 percent share of the market. Koke International had done such an excellent job of positioning itself in its field that articles in major business newspapers were calling it "the Microsoft of home improvements." The view was that "KI is going to continue to be a very profitable enterprise, with less expected direct competition in a slow-growth, high-margin market for the future."

Wendy, Victoria's boss, had brought her in on KI's next potential conquest: the New England states of Maine, Vermont, New Hampshire, Connecticut, and Massachusetts.

"This is the last big potential market," Wendy said at a planning session with her senior staff. "I want you to realize that when we launch into these states we're going to have to be ruthless. I'd like your suggestions as to how we're going to eliminate the competition."

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One person spoke up: “We first need to recognize that there are only five major players (multiple-store chains), with Home Designs being the largest.”

“The top corporate people want us to attack Maine, New Hampshire, and Vermont first and then make a secondary attack on the other two states,” interjected Victoria.

“Our buildings are four months from completion,” Wendy pointed out, “and the media blitz is due to start one month prior to the 20-store grand opening. With that much exposed capital from our franchises, we need to make sure everything goes well. Vicky, have you completed your price analysis of all of the surrounding home repair stores?”

“Yes, and you’re not going to like the news,” Victoria replied. “Many of the stores are going to be extremely competitive relative to our normal pricing. In a few cases, they seem to have an edge.”

Wendy turned to Ed. “Ed, how much cash reserves have you been able to calculate from the five players?”

“Well, Wendy, it looks like if we slash our prices for about six months to a year, we could drive all but Home Designs into near bankruptcy, providing that our promotional campaign doesn’t have a misstep.”

“What about personnel, Frank?” Wendy cut in. “Have you done the usual research to see about hiring away the five players’ key personnel?”

“Yes, but many won’t go unless they get a 50 percent raise, which is way out of line with our other stores.”

At this point, Wendy slammed her fist on the table and shouted, “I’m tired of hearing negative reports! It’s our job to drive out the competition, and I want solutions!”

There was a long silence in the room. Wendy was noted for her quick temper and her quick firings when things didn’t go as planned. She had been the first woman to make it this high in the company, and it wasn’t the result of being overly pleasant.

“So this is what we’re going to do,” Wendy said softly. “Frank, you’re going to hire those key people at a 50 percent increase. You’re going to keep the unions away from the rest of the people. In 18 months, when these overpriced employees have trained the others, we’ll find some way of getting rid of them. Ed, you’re going to lean on the players’ bankers. See if we do business with them as well. See what other information you can squeeze out of them. Victoria, since you’re the newest, I’m putting you in charge of breaking the pricing problem. I want you to come up with a unique pricing strategy for each of the 20 stores that will consistently undercut the competition for the next 18 months, even if we have to lose money on everything in the stores! The franchisees will go with this once we explain the payout.”

One of the newer staff members asked, “If we’re successful, doesn’t that make us a monopoly in the area? Don’t we have to worry about antitrust issues?”

Wendy raised her eyebrow a little and said, “We don’t mention the word *monopoly* around here as if it were a dirty word. It took the Feds decades to break up AT&T. Microsoft was next on their list, and now it’s MasterCard. We’re in retail. No one has ever had problems with the Feds in this industry. By the time they get around to dealing with what we’re doing, we will all be retired.”

QUESTIONS | EXERCISES

1. Identify the issues of which Victoria needs to be aware.
2. Discuss the implications of each decision that Wendy made.
3. Discuss why the federal government has determined that monopolies are not in the public’s best interest.

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Programs that are designed to foster ethical decision making in business are controversial today because much unethical and illegal business conduct has continued to occur even in organizations that have adopted such programs. Many companies that had codes of ethics were ruined by unethical activities and corporate scandals. Enron, AIG, and Merrill Lynch are all examples of organizations with codes of ethics that nonetheless

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experienced ethical disasters. Many business leaders believe that ethics initiatives should arise naturally from a company's corporate culture and that simply hiring good employees will limit unethical conduct. Moreover, many business executives and board members often do not understand how organizational ethics can be systematically implemented. In business, many ethical issues are very complex and require that organizations reach a consensus on appropriate action. Top executives and boards of directors must provide the leadership and a system with which to resolve these issues. Legislation and regulatory rules require leadership to create and implement effective ethics programs. These requirements come into play when misconduct is investigated by the government. We believe that customized ethics and compliance programs will help businesses provide guidance such that employees from diverse backgrounds will understand what behaviors are acceptable (and unacceptable) within the organization.

Business ethics programs have the potential to help top managers establish an ethical culture and eliminate the opportunity for unethical conduct. This chapter therefore provides a framework for developing an ethics program that is consistent with research, best practices, and the decision-making process described in Chapter 5, as well as with the Federal Sentencing Guidelines for Organizations (FSGO), the Sarbanes–Oxley Act, and the Dodd–Frank Act described in Chapter 4. These legislative reforms require both executives and boards of directors to assume responsibility and ensure that ethical standards are properly implemented on a daily basis.

In this chapter, we first examine the corporation as a social entity, and then provide an overview of why businesses need to develop organizational ethics programs. Next, we consider the factors that must be part of such a program: a code of conduct, an ethics officer and the appropriate delegation of authority, an effective ethics-training program, a system for monitoring and supporting ethical compliance, and continual efforts to improve the ethics program. Finally, we consider common mistakes in designing and implementing ethics programs.

THE RESPONSIBILITY OF THE CORPORATION AS A MORAL AGENT

Increasingly, corporations are viewed not merely as profit-making entities but also as moral agents that are accountable for their conduct to their stakeholders, including employees, investors, suppliers, government, and customers. Companies are more than the sum of their parts or participants. Because corporations are chartered as citizens of a state and/or nation, they generally have the same rights and responsibilities as individuals. Through legislation and court precedents, society holds companies accountable for the conduct of their employees as well as for their decisions and the consequences of those decisions. Coverage in the news media of specific issues such as employee benefits, executive compensation, defective products, competitive practices, and financial reporting contributes to a firm's reputation as a moral agent.

As moral agents, companies are required to obey the laws and regulations that define acceptable business conduct. However, it is important to acknowledge that they are not human beings who can think through moral issues. Because companies are not human, laws and regulations are necessary to provide formal structural restraints and guidance on ethical issues. Employees have a moral obligation to responsibly think through complex

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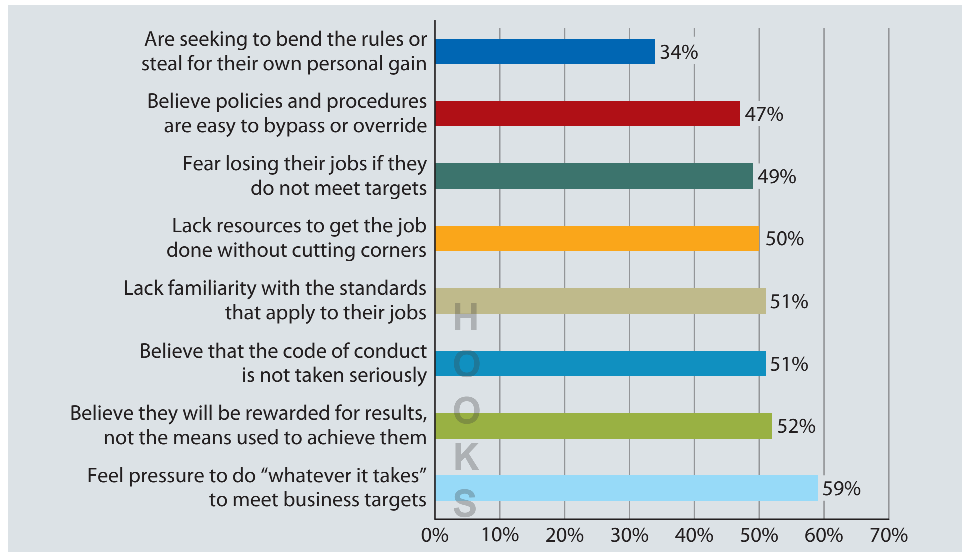
FIGURE 8.1 Root Causes of Misconduct



Source: KPMG Forensic Integrity Survey: 2008–2009, http://www.kpmg.com/SiteCollectionDocuments/Integrity-Survey-2008-2009.pdf, p. 6 (accessed August 20, 2009).

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ethical issues to contribute to the ethical conduct of the corporation as a whole.[1] Figure 8.1 illustrates the basic causes of individual misconduct. The key reason why people seem to engage in misconduct is because they feel pressured to do "whatever it takes to meet business targets."

Though obviously not a person, a corporation can be considered a moral agent in society, one that has been created to perform specific social functions and is therefore responsible to society for its actions. Because corporations have the characteristics of agents, responsibility for ethical behavior is assigned to them as legal entities, as well as to individuals or work groups they employ. As Figure 8.1 indicates, a corporate culture without values and appropriate communication about ethics can facilitate individual misconduct. Some corporate outcomes cannot be tied to one individual or even a group, and misconduct can be the result of a collective pattern of decisions supported by a corporate culture. Therefore, corporations can be held accountable when they are found to be operating in a manner inconsistent with major legal requirements. Some organizations receive such large fines and negative publicity that they have to go out of business. On the other hand, companies that have been selected as top corporate citizens, including Google, Salesforce.com, IKEA, and AstraZeneca, receive awards and recognition for being responsible moral agents in society.[2]

In many cases, a coherent ethical corporate culture does not evolve through independent individual and interpersonal relationships. Because ethics is often viewed as an individual matter, many reason that the best way to develop an ethical corporate culture is to provide character education to employees or to hire individuals with good character and sensitize them to ethical issues. This theory assumes that ethical conduct will develop through company-wide agreement and consensus. Although these assumptions are laudable and contain some truth, companies that are responsible for most of the economic activity in the world employ thousands of culturally diverse individuals who will never reach

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agreement on all ethical issues. Many ethical business issues are complex close calls, and the only way to ensure consistent decisions that represent the interests of all stakeholders is to require ethical policies. This chapter provides support for the idea that implementing a centralized corporate ethics program can provide a cohesive, internally consistent set of statements and policies representing the corporation as a moral agent.

THE NEED FOR ORGANIZATIONAL ETHICS PROGRAMS

To understand why companies need to develop ethics programs, judge whether each of the following actions is unethical versus illegal.

- You want to skip work to go to a baseball game, but you need a doctor's excuse, so you make up some symptoms so that your insurance company pays for the doctor's visit. (unethical, illegal)
- While having a latte at a local café, you run into an acquaintance who works as a salesperson for a competing firm. You wind up chatting about future product prices. When you get back to your office, you tell your supervisor what you heard. (unethical, illegal)
- You are fired from your company, but before leaving for a position with another company, you copy a confidential list of client names and telephone numbers that you compiled for your former employer. (unethical, illegal)
- You receive a loan from your parents to make the down payment on your first home, but when describing the source of the down payment on the mortgage application, you characterize it as a gift. (unethical, illegal)
- Your manager asks you to book some sales revenue from the next quarter into this quarter's sales report to help the firm reach target sales figures. You agree to do so. (unethical, illegal)

You probably labeled one or more of these five scenarios as unethical rather than illegal. The reality is that all of them have the potential to be illegal. You may have chosen incorrectly because it is nearly impossible to know every detail of the highly complex laws relevant to these situations. Consider that there are 10,000 laws and regulations associated with the processing and selling of a single hamburger. Unless you are a lawyer who specializes in a particular area, it is difficult to know every law associated with your job. However, you can become more sensitized to what might be unethical or, in these cases, illegal. One reason why ethics programs are required in one form or another is to help sensitize employees to the potential legal and ethical issues within their work environments.

As we have mentioned throughout this book, ethics scandals in U.S. businesses have destroyed employees' trust in top management and significantly lowered the public's trust of business. And government agencies are not immune from this growing distrust. After it was revealed that the former legal counsel for the Securities and Exchange Commission had inherited money generated through investments with Bernard Madoff, the public was outraged that he had not recused himself from decisions related to the Madoff fraud. Since he had profited—albeit indirectly—from the Madoff fraud, many thought that his participation represented a serious conflict of interest. This occurrence led the SEC to announce a review of the agency's ethics program, particularly its conflict-of-interest policies.[3]

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Pepsi CEO Indra Nooyi believes that all businesses are challenged to help restore consumer confidence and trust. She stated that rebuilding trust will require "all companies to think again about what they do to build trust, and to think again about how they make, give, and add value. And most of all, it will require all companies to ensure that they embrace not just the commercial idea of value, but the ethical ideal of values too."[4] Understanding the factors that influence the ethical decision-making process, as discussed in Chapter 5, can help companies encourage ethical behavior and discourage undesirable conduct. Fostering ethical decision making within an organization requires terminating unethical employees and improving the firm's ethical standards. Consider the "bad apple–bad barrel" analogy. Some people are simply "bad apples" who will always do things in their own self-interest regardless of their organization's goals or accepted standards of conduct.[5] For example, Raj Rajaratnam, co-founder of the hedge fund Galleon Group, allegedly used a "corrupt network" of consultants to make illegal profits. According to prosecutors, Rajaratnam and employees at Galleon Group engaged in insider trading on over 35 stocks, generating $45 million in profits. The corporate culture at Galleon Group appears to have promoted illegal behavior simply as a way of doing business.[6] Eliminating such bad apples through screening techniques and enforcement of a firm's ethical standards can help improve the firm's overall behavior.[7]

Organizations can also become "bad barrels," not because the individuals within them are bad, but because the pressures to succeed create opportunities that reward unethical decisions. In the case of such bad barrels, firms must redesign their image and culture to conform to industry and social standards of acceptable behavior.[8] Most companies attempt to improve ethical decision making by establishing and implementing a strategic approach to improving their organizations' ethics. Companies as diverse as Texas Instruments, Starbucks, Ford Motor Co., and Whole Foods have adopted a strategic approach to organizational ethics. They continuously monitor their programs and make adjustments when problems occur.

To promote legal and ethical conduct, an organization should develop an organizational ethics program by establishing, communicating, and monitoring the ethical values and legal requirements that characterize its history, culture, industry, and operating environment. Without such programs, uniform standards, and policies of conduct, it is difficult for employees to determine what behaviors are acceptable within a company. As discussed in Chapters 6 and 7, in the absence of such programs and standards, employees will generally make decisions based on their own observations of how their coworkers and superiors behave. A strong ethics program includes a written code of conduct; an ethics officer to oversee the program; careful delegation of authority; formal ethics training; and rigorous auditing, monitoring, enforcement, and revision of program standards. Without a strong program, problems are likely to occur. For example, despite laws protecting intellectual property in China, weak compliance programs have created piracy problems for businesses. One business that has been accused of Internet piracy is Baidu, the most popular search engine in China. Music companies have accused Baidu's MP3 service of allowing users to download songs without paying the copyright owners. Baidu, on the other hand, claims that it is acting legitimately and simply linking users to music websites. After a lawsuit was filed, the Chinese government ruled in favor of Baidu.[9]

Although there are no universal standards that can be applied to organizational ethics programs, most companies develop codes, values, or policies to provide guidance on business conduct. However, it would be naïve to think that simply having a code of ethics will solve all the ethical dilemmas that a company might face.[10] Indeed, most of the companies

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that have experienced ethical and legal difficulties in recent years have had formal ethics codes and programs. The problem is that top managers have not integrated these codes, values, and standards into their firms' corporate cultures where they can provide effective guidance for daily decision making. High-status officials like top managers may be more inclined to engage in unethical organizational conduct because of social isolation that creates insensitivity and a lower motivation to regulate ethical decision making.[11] Top managers tend to focus on financial performance because their jobs and personal identities are often intimately connected to their firms' quarterly returns. A culture of short-term performance as a company's highest priority can diminish ethical decision making. On the other hand, corporations owned by Warren Buffett's Berkshire Hathaway, such as Burlington Northern Santa Fe and GEICO, are not subject to Wall Street's quarterly returns and can focus on an unusual commitment to long-run performance and responsible conduct.[12]

> **"A culture of short-term performance as a company's highest priority can diminish ethical decision making."**

If a company's leadership fails to provide the vision and support needed for ethical conduct, then an ethics program will not be effective. Ethics is not something to be delegated to lower-level employees. To satisfy the public's escalating demands for ethical decision making, companies need to develop plans and structures for addressing ethical considerations. Some directions for improving ethics have been mandated through regulations, but companies must be willing to put in place a system for implementing values and ethics that exceeds the minimum requirements.

AN EFFECTIVE ETHICS PROGRAM

Throughout this book, we have emphasized that ethical issues are at the forefront of organizational concerns as managers and employees face increasingly complex decisions. These decisions are often made in a group environment composed of different value systems, competitive pressures, and political concerns that contribute to the opportunity for misconduct. The more misconduct occurs at a company, the less trust employees feel toward the organization—and the greater the turnover will likely be. A Deloitte LLP Ethics & Workplace survey indicated that 48 percent of employee respondents who were looking for a new job cited a loss of workplace trust as the primary reason for their departure. About 40 percent indicated unethical treatment as the reason.[13] When opportunities to engage in unethical conduct abound, companies are vulnerable to both ethical problems and legal violations if their employees do not know how to make the right decisions.

A company must have an effective ethics program to ensure that all employees understand its values and comply with the policies and codes of conduct that create its ethical culture. If the culture encourages unethical conduct, then misconduct is likely to occur even if the company has ethical guidelines in place. Consider that a French court sentenced a Société Générale trader to three years in prison for his role in one of the world's biggest trading scandals. The trader and his lawyers claimed that the company ignored red flags because the trader was making the company so much money. Even the bank admitted that it shared some of the responsibility for the misconduct.[14]

Because we come from diverse business, educational, and family backgrounds, it cannot be assumed that we know how to behave appropriately when we enter a new organization or job. The pharmaceutical company Merck requires all employees to be responsible

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for supporting its Code of Business Conduct, which is available in 27 languages. Employees take classes in ethics to help them understand how to resolve ethical dilemmas in the workplace, as well as receiving online training to raise their awareness of ethical issues and assist them in maintaining an ethical organizational culture.[15] According to a fraud survey, 66 percent of executives feel that inadequate ethics and compliance programs are the reason for much of the unchecked misconduct in business.[16] It would therefore appear that the creation of effective ethics programs like Merck's Code of Business Conduct are important deterrents to organizational misconduct.

An Ethics Program Can Help Avoid Legal Problems

As mentioned in Chapter 7, some corporate cultures provide opportunities for or reward unethical conduct because their management is not sufficiently concerned about ethics or because the company has failed to comply with the minimum requirements of the FSGO (Table 8.1). Companies may face penalties and the loss of public confidence if one of their employees breaks the law. The FSGO encourages companies to assess their key risk areas and to customize a compliance program that will address these risks and satisfy key effectiveness criteria. The guidelines also hold companies responsible for the misconduct of their employees. Indeed, an Ernst & Young global survey of over 1,400 CFOs and heads of internal audit, legal, and compliance divisions in major corporations revealed that while instances of fraud are rising in some regions, reported fraud in the United States. has been decreasing. Figure 8.2 shows the percentage of boards within Latin America, the Middle East, Africa, Europe, Australia, and North America that are concerned about key risk areas related to corporate bribery, fraud, and corruption. Note that although 72 percent of boards in North America have such concerns, the survey indicates that U.S. boards are beginning to ask more questions in an attempt to root out bribery and fraud within their companies.[17] Ethics programs that provide guidelines outlining board responsibilities encourage compliance at the highest levels of the organization.

At the heart of the FSGO is a "carrot-and-stick" philosophy. Companies that act to prevent misconduct by establishing and enforcing ethical and legal compliance programs may receive a "carrot" and avoid penalties should a violation occur. The ultimate "stick" is the possibility of being fined or put on probation if convicted of a crime. Organizational probation involves using on-site consultants to observe and monitor a company's legal compliance efforts as well as to report the company's progress toward avoiding misconduct to the

TABLE 8.1 Minimum Requirements for Ethics and Compliance Programs

1. Standards and procedures, such as codes of ethics, that are reasonably capable of detecting and preventing misconduct
2. High-level personnel who are responsible for an ethics and compliance program
3. No substantial discretionary authority given to individuals with a propensity for misconduct
4. Standards and procedures communicated effectively via ethics training programs
5. Systems to monitor, audit, and report misconduct
6. Consistent enforcement of standards, codes, and punishment
7. Continuous improvement of the ethics and compliance program

Source: Adapted from U.S. Sentencing Commission, *Federal Sentencing Guidelines Manual,* effective November 1, 2004 (St. Paul, MN: West, 2008).

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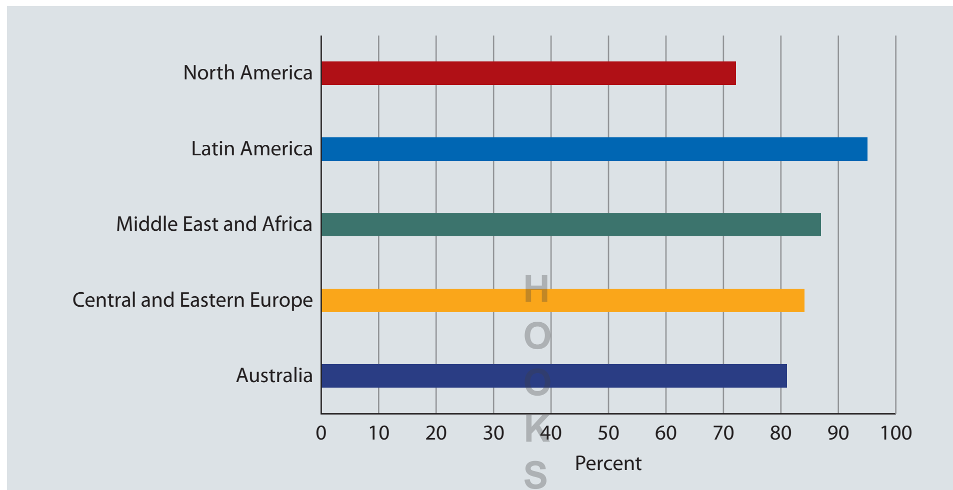
FIGURE 8.2 Percentage of Boards in Different Countries that are Concerned About Their Personal Liability for Corporate Fraud, Bribery, and Corruption



Source: "Global Survey Shows Business Fraud Up," *Corporate Compliance Insights,* May 19, 2010, http://www.corporatecomplianceinsights.com/2010/global-survey-shows-business-fraud-up-boards-have-increased-concern-about-liability/?pfstyle=wp (accessed March 15, 2011).

U.S. Sentencing Commission. Table 8.2 shows the fines that the Securities and Exchange Commission has levied against well-known firms for corporate misconduct.

The FSGO encourages federal judges to increase fines for organizations that continually tolerate misconduct and to reduce or eliminate fines for firms with extensive compliance programs that are making due diligence attempts to abide by legal and ethical standards. Until the guidelines were formulated, courts were inconsistent in holding corporations responsible for employee misconduct. There was no incentive to build effective programs to encourage employees to make ethical and legal decisions. Now companies earn credit for creating ethics programs that meet a rigorous standard. The effectiveness of a program is determined by its design and implementation. In other words, it must deal effectively with the risks associated with a particular business, and it must become part of the corporate culture.

An ethics program can help a firm avoid civil liability, but the company still bears the burden of proving that it has an effective program. A program developed in the absence of misconduct will be much more effective than one imposed as a reaction to scandal or

TABLE 8.2 Penalties for Corporate Misconduct

Company	Penalty	Reason
WorldCom	$750 million	Accounting fraud
Goldman Sachs	$550 million	Misleading investors
Fannie Mae	$400 million	Accounting fraud
Time Warner	$300 million	Accounting fraud
Qwest	$250 million	Accounting fraud

Source: Matt Phillips, "SEC's Greatest Hits: Biggest. Penalties. Ever." *The Wall Street Journal,* July 16, 2010, http://blogs.wsj.com/marketbeat/2010/07/16/secs-greatest-hits-some-of-the-other-biggest-penalties/ (accessed March 13, 2011).

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prosecution. A legal test of a company's ethics program may occur when an individual employee is charged with misconduct. The court system or the U.S. Sentencing Commission evaluates the organization's responsibility for the individual's behavior during the process of an investigation. If the courts find that the company contributed to the misconduct or failed to show due diligence in preventing misconduct, then the firm may be convicted and sentenced.

Values versus Compliance Programs

No matter what their goals, ethics programs are developed as organizational control systems, the aim of which is to create predictability in employee behavior. Two types of control systems can be created. A **compliance orientation** creates order by requiring that employees identify with and commit to specific required conduct. It uses legal terms, statutes, and contracts that teach employees the rules and penalties for noncompliance. The other type of system is a **values orientation,** which strives to develop shared values. Although penalties are attached, the focus is more on an abstract core of ideals such as accountability and commitment. Studies have found that when personal and organizational values are compatible with one another, it tends to positively influence workplace ethics.[18]

The advantage of a values orientation is that it gives employees a clearly defined basis on which to make decisions, one in which fairness, compassion, respect, and transparency are paramount. At the same time, diversity in employees' experience and personal values requires explicit communication and training on subject matter areas such as financial reporting, use of company resources, and intellectual property. Establishing compliance standards helps employees understand rules of conduct when there are identified risks. For example, rules on the recruiting and hiring of new employees will help enforce company policy and prevent legal violations. When there are new, unexpected, or ambiguous issues with no compliance requirements, values may help the employee navigate through the ethical issues at hand.

Research into compliance- and values-based approaches reveals that both types of programs can interact or work toward the same end but that a values orientation has the added benefit of sparking ethical reasoning among employees. Values-based programs increase employees' awareness of ethics at work, their integrity, their willingness to deliver information to supervisors, their use of reporting mechanisms, and their perception that better ethical decisions are being made. Compliance-based programs are linked to employees' awareness of ethical risks at work and to a clear understanding of rules and expectations that facilitates decision making. In the final analysis, both orientations can be used to help employees and managers; however, a values-based program is the foundation of an organizational ethical culture.

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CODES OF CONDUCT

As the perception of business accountability has changed over the years, expectations for organizational codes of ethics have grown. Today, society expects to see employees adhere to ethical principles and standards specified through company ethics programs.[19] Most companies begin the process of establishing organizational ethics programs by developing

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codes of conduct, which are formal statements that describe what an organization expects of its employees. Such statements may take three different forms: a code of ethics, a code of conduct, and a statement of values. A **code of ethics** is the most comprehensive and consists of general statements, sometimes altruistic or inspirational, that serve as principles and as the basis for rules of conduct. A code of ethics generally specifies methods for reporting violations, disciplinary action for violations, and a structure of due process. Table 8.3 describes some benefits of having a comprehensive code of conduct. A code of conduct is a written document that may contain some inspirational statements but that mainly specifies acceptable and unacceptable types of behavior. A code of conduct is more akin to a regulatory set of rules and, as such, tends to elicit less debate about specific actions. Some of the key reasons that codes of ethics fail are that (1) the code is not promoted and employees do not read it; (2) the code is not easily accessible; (3) the code is written too legalistically and therefore is not understandable by average employees; (4) the code is written too vaguely, providing no accurate direction; and (5) top management never refers to the code in body or spirit.[20]

The final type of ethical statement is a **statement of values,** which serves the general public and also addresses distinct groups such as stakeholders. Values statements are conceived by management and are fully developed with input from all stakeholders. Despite the distinction made in this book between a code of ethics and a values statement, it is important to recognize that these terms are often used interchangeably.

DEBATE ISSUE TAKE A STAND

Examining Banking and Insurance Companies' Codes of Conduct

The financial industry was blamed for significant misconduct that contributed to the last major recession. Codes of conduct, sometimes referred to as codes of ethics, should provide behavioral expectations that an organization maintains for its managers, employees, and agents. The Ethisphere Institute has developed a grade methodology for evaluating codes of conduct, using the criteria of public availability, tone from the top, readability and tone, non-retaliation and reporting, values and commitments, risk topics, comprehension aids, and presentation and style. Of the 25 companies evaluated in the banking industry, only two banks received a relatively high ranking. In the insurance industry, only two companies received above a C rating. It is interesting that in the banking industry, 19 of the 25 companies received an F for tone at the top, indicating a lack of communication from the CEO or Chairman of the Board. This seems to suggest that misconduct tends to occur more frequently in organizations with badly written codes of conduct.[21]

1. The Ethisphere Institute's analysis of banking and insurance codes of conduct explains why widespread misconduct has been so prevalent in the financial industry.
2. Written codes of conduct are only a small part of the ethical culture of a company and cannot by themselves explain why misconduct has been so widespread in the financial industry.

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Regardless of its degree of comprehensiveness, a code of ethics should reflect upper managers' desires for compliance with the values, rules, and policies that support an ethical culture. The development of a code of ethics should involve the president, board of directors, and chief executive officers who will be implementing the code. Legal staff should also be called on to ensure that the code has correctly assessed key areas of risk and that it provides buffers for potential legal problems. A code of ethics that does not address specific high-risk activities within the scope of daily operations is inadequate for maintaining standards that can prevent misconduct. Table 8.4 shows factors to consider when developing and implementing a code of ethics.

Codes of ethics may address a variety of situations, from internal operations to sales presentations and financial disclosure practices. Research has found that corporate

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TABLE 8.3 Benefits of Having an Ethics Code

A Comprehensive Code of Conduct Can...
1. Guide employees in situations where the ethical course of action is not immediately obvious.
2. Help the company reinforce—and acquaint new employees with—its culture and values. A code can help create a climate of integrity and excellence.
3. Help the company communicate its expectations for its staff to suppliers, vendors, and customers.
4. Minimize subjective and inconsistent management standards.
5. Help a company remain in compliance with complex government regulations.
6. Build public trust and enhance business reputations.
7. Offer protection in preempting or defending against lawsuits.
8. Enhance morale, employee pride, loyalty, and the recruitment of outstanding employees.
9. Help promote constructive social change by raising awareness of the community's needs and encouraging employees and other stakeholders to help.
10. Promote market efficiency, especially in areas where laws are weak or inefficient, by rewarding the best and most ethical producers of goods and services.

Source: "Ten Benefits of Having an Ethics Code," Josephson Institute Center for Business Ethics, http://josephsoninstitute.org/business/blog/2010/11/ten-benefits-of-having-an-ethics-code/ (accessed March 14, 2010). Originally adapted from *Good Ideas for Creating a More Ethical and Effective Workplace.*

TABLE 8.4 Developing and Implementing a Code of Ethics

1.	Consider areas of risk and state the values as well as conduct necessary to comply with laws and regulations. Values are an important buffer in preventing serious misconduct.
2.	Identify values that specifically address current ethical issues.
3.	Consider values that link the organization to a stakeholder orientation. Attempt to find overlaps in organizational and stakeholder values.
4.	Make the code understandable by providing examples that reflect values.
5.	Communicate the code frequently and in language that employees can understand.
6.	Revise the code every year with input from organizational members and stakeholders.

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codes of ethics often contain about six core values or principles in addition to more detailed descriptions and examples of appropriate conduct.[22] The six values that have been suggested as being desirable for codes of ethics are (1) trustworthiness, (2) respect, (3) responsibility, (4) fairness, (5) caring, and (6) citizenship.[23] These values will not be effective without distribution, training, and the support of top management in making these values a part of the corporate culture. Employees need specific examples of how these values can be implemented.

Research has demonstrated that employees at organizations with effective ethical codes of conduct tend to be less tolerant of unethical behavior toward stakeholders

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than those at companies without ethical codes.[24] Codes of conduct will not resolve every ethical issue encountered in daily operations, but they help employees and managers deal with ethical dilemmas by prescribing or limiting specific activities. Many companies have a code of ethics, but it is not communicated effectively. A code that is placed on a website or in a training manual is useless if it is not reinforced every day. By communicating to employees both what is expected of them and what punishments they face if they violate the rules, codes of conduct curtail opportunities for unethical behavior and thereby improve ethical decision making. For example, the American Society for Civil Engineers' code of ethics specifies that engineers must act with zero tolerance toward bribery, fraud, and corruption in all engineering and construction projects in which they are engaged.[25] Codes of conduct do not have to be so detailed that they take into account every situation, but they should provide guidelines and principles that are capable of helping employees achieve organizational ethical objectives and address risks in an accepted way.

In Japan, Kao Corporation has gained recognition for its leading ethics programs. The company has won numerous ethics awards as well as the Environmental Technology Award from the Japan Chemical Industry Association. It is also the only Japanese company to be included on *Ethisphere*'s World's Most Ethical Companies list for four consecutive years. Kao is extremely focused on ethics and integrity. The company ensures that its employees are provided with training in ethics and in the characteristics and cultures of other countries. Kao has also created new ecofriendly products that will save resources and that are well-suited to areas like China, where water is scarce.[26] Ethics programs are essential in large corporations such as Kao Corporation. However, it is not only large companies that need to develop an ethics and compliance program; small companies need to do so as well.

ETHICS OFFICERS

Organizational ethics programs must have oversight by high-ranking persons known to respect legal and ethical standards. These individuals—often referred to as **ethics officers**—are responsible for managing their organizations' ethics and legal compliance programs. They are usually responsible for (1) assessing the needs and risks that an organization-wide ethics program must address, (2) developing and distributing a code of conduct or ethics, (3) conducting training programs for employees, (4) establishing and maintaining a confidential service to answer employees' questions about ethical issues, (5) making sure that the company is in compliance with government regulation, (6) monitoring and auditing ethical conduct, (7) taking action on possible violations of the company's code, and (8) reviewing and updating the code. Ethics officers are also responsible for knowing thousands of pages of relevant regulations as well as communicating and reinforcing values that build an ethical corporate culture. The Ethics Resource Center reports that having a comprehensive ethics program in place, one that includes an ethics officer, helps companies reduce incidences of misconduct by as much as 75 percent. However, only 9 percent of corporations included in the survey have an ethics program deemed comprehensive by the ERC.[27] Corporate wrongdoings and scandal-grabbing headlines have a profound negative impact on public trust. To ensure compliance with state and federal regulations, many corporations are now appointing

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chief compliance officers and ethics and business conduct professionals to develop and oversee corporate compliance programs.[28]

The Ethics and Compliance Officer Association (ECOA) has over 1,200 members who are frontline managers of ethics programs in over 30 countries.[29] Ethics officers often move into their position from other jobs in their companies. Ethics and compliance officers have backgrounds in law, finance, and human resource management. Sarbanes–Oxley and the amendments to the FSGO have increased the responsibility that ethics officers and boards of directors have for oversight of financial reporting. Ethics officers' positions are still relatively new and somewhat ill-defined. Although tough economic times call all expenditures into question, economic uncertainty brings about the greatest need for an investment in and formalization of the ethics and compliance roles within an organization. Times of economic distress tend to generate significant organizational and individual wrongdoing.[30]

Although recommended as best practice, it is not common for ethics officers to report directly to the board of directors. Ethics officers often report directly to the chief executive officer and may have some access to the board. In a survey of chief financial officers, more than 30 percent indicated that their operations had been impacted or disrupted by unexpected circumstances in the past year. Oversight, monitoring, and review of operating procedures and outcomes by the ethics and compliance function can prevent such surprises.[31]

ETHICS TRAINING AND COMMUNICATION

A major step in developing an effective ethics program is implementing a training program and communication system to educate employees about the firm's ethical standards. The National Business Ethics Survey looked at 18 dimensions of ethical culture and formal programs and found that companies with strong ethical cultures and formal ethics programs were 36 percentage points less likely to observe misconduct than employees in organizations with weak cultures and ethics programs.[32] A significant number of employees report that they frequently find such training useful. Training can educate employees about the firm's policies and expectations, relevant laws and regulations, and general social standards. Training programs can also make employees aware of available resources, support systems, and designated personnel who can assist them with ethical and legal advice. They can empower employees to ask tough questions and make ethical decisions. Many organizations are now incorporating ethics training into their employee and management development training efforts. For instance, the National Science Foundation (NSF) adopted new ethics rules that require researchers who receive grants to undergo ethics training. Starting in 2010, NSF grant recipients must participate in a formal training program to educate them on ethical research techniques and oversight.[33] Sometimes governments mandate ethics training for officials. In Russia, President Vladimir Putin ordered drivers with blue lights on their vehicles to undergo professional ethics training after other drivers complained of unruly behavior. Blue lights are used by Russian police officers, government and emergency vehicles, and many middle-ranking state officials (they can also be obtained illegally for bribes). Several owners of these blue lights have harassed or even injured others who would or could not get out of their way on the roads. This unethical behavior prompted Putin to order mandatory ethics training in the hopes of preventing future misconduct.[34]

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As we emphasized in Chapters 5 and 7, ethical decision making is influenced by corporate culture, by coworkers and supervisors, and by the opportunities available to engage in unethical behavior. Ethics training can impact all three types of influence. Full awareness of a company's philosophy of management, rules, and procedures can strengthen both the corporate culture and the ethical stance of peers and supervisors. Such awareness, too, arms employees against opportunities for unethical behavior and lessens the likelihood of misconduct. Thus, the existence and enforcement of company rules and procedures limit unethical practices in the organization. If adequately and thoughtfully designed, ethics training can make employees aware of ethical issues, increase the importance of ethics training to employees, and increase employees' confidence that they can make the correct decision when faced with an ethical dilemma.[35] If ethics training is to be effective, it must start with a theoretical foundation, a code of ethics, a procedure for airing ethical concerns, line and staff involvements, and clear executive priorities on ethics, all of which must be communicated to employees. Managers from every department must be involved in the development of an ethics training program. Training and communication initiatives should reflect the unique characteristics of an organization: its size, culture, values, management style, and employee base. To be successful, business ethics programs should educate employees about formal ethical frameworks and models for analyzing business ethics issues. Then employees can base ethical decisions on their knowledge of choices rather than on emotions.

"The existence and enforcement of company rules and procedures limit unethical practices in the organization."

A key component of managing an effective and efficient ethics and compliance program is a firm grasp of techniques that clearly communicate the company's culture, policies, and procedures for dealing with ethical issues to employees. Many feel that "hands on" training in which employees are forced to confront actual or hypothetical ethical dilemmas helps them to understand how their organization would like them to deal with potential problems. Lockheed Martin, for example, has developed training games that include dilemmas that can be resolved in teams. Each team member can offer his or her perspective, thereby helping other team members fully understand the ramifications of a decision for coworkers and the organization.

Another training device is the behavioral simulation, which gives participants a short, hypothetical ethical issue situation to review. Each participant is assigned a role within a hypothetical organization and is provided with varying levels of information about the scenario. Participants must then interact to develop recommended courses of action representing short-term, mid-term, and long-term considerations. Such simulations recreate the complexities of organizational relationships as well as the realities of having to address difficult situations with incomplete information. They help participants gain awareness of the ethical, legal, and social dimensions of business decision making; develop analytical skills for resolving ethical issues; and gain exposure to the complexity of ethical decision making in organizations. Research indicates that "the simulation not only instructs on the importance of ethics but on the processes for managing ethical concerns and conflict."[36]

Top executives must communicate with managers at the operations level (in production, sales, and finance, for instance) and enforce overall ethical standards within the organization. Table 8.5 lists the goals for successful ethics training. Making employees aware of the key risk areas for their occupation or profession is of a major importance in any

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TABLE 8.5 Key Goals of Successful Ethics Training Programs

1. Identify key risk areas that employees will face.
2. Provide experience in dealing with hypothetical or disguised ethical issues within the industry through mini-cases, online challenges, CD-ROMs, or other experiential learning opportunities.
3. Let employees know that wrongdoing will never be supported in the organization and that employee evaluations will take their conduct in this area into consideration.
4. Let employees know that they are individually accountable for their behavior.
5. Align employee conduct with organizational reputation and branding.
6. Provide ongoing feedback to employees about how they are handling ethical issues.
7. Allow a mechanism for employees to voice their concerns that is anonymous, but that provides answers to key questions (24-hour hotlines).
8. Provide a hierarchy of leadership for employees to contact when they are faced with an ethical dilemma that they do not know how to resolve.

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ethics training program. In addition, employees need to know whom to contact for guidance when they encounter gray areas in which the organization's values, rules, policies, and training do not provide adequate direction.

Although training and communication should reinforce values and provide employees with opportunities to learn about rules, they represent just one aspect of an effective ethics program. Moreover, ethics training will be ineffective if conducted solely because it is required or because it is something that competing firms are doing. For example, Enron had an ethics program in place. However, unethical executives knew they had the support of Arthur Andersen, the firm's auditing and accounting consulting partner, as well as that of law firms, investment analysts, and in some cases, government regulators. Enron's top managers therefore probably believed that their efforts to hide debt in off-balance-sheet partnerships would not be exposed.

When measuring the effectiveness of an ethics program, it is important to get input from employees. Employee surveys and the incorporation of ethics measurements in performance appraisal systems are two ways to help determine the effectiveness of a firm's ethics training. If ethical performance is not a part of regular performance appraisals, employees will get the message that ethics is not an important component of decision making in their company. For ethics training to make a difference, employees must understand why it is conducted, how it fits into the organization, and what their own role in implementing it is.

SYSTEMS TO MONITOR AND ENFORCE ETHICAL STANDARDS

An effective ethics program employs a variety of resources to monitor ethical conduct and measure the program's effectiveness. Observing employees, conducting internal audits and investigations, circulating surveys, and instituting reporting systems are ways that a

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company can assess compliance with its ethical code and standards. An external audit and review of company activities may sometimes be helpful in developing benchmarks of compliance. (We examine the process of ethical auditing in Chapter 9.)

To determine whether a person is performing his or her job adequately and ethically, observers might focus on how the employee handles an ethically charged situation. Many businesses employ role-playing exercises when they train salespeople and managers. Ethical issues can be introduced into the discussion, and the results can be videotaped so that both participants and their superiors can evaluate the outcome of the ethics dilemma.

Questionnaires can serve as benchmarks in an ongoing assessment of ethical performance by measuring employees' ethical perceptions of their company, their superiors, their coworkers, and themselves, as well as by serving as a means of developing ratings of ethical or unethical practices within their firm and industry. Then, if unethical conduct appears to be increasing, management will have a better understanding of what types of unethical practices may be occurring and why. A change in the company's ethics training may then be necessary.

The existence of an internal system by which employees can report misconduct is especially useful for monitoring and evaluating ethical performance. Many companies set up ethics assistance lines, also known as hotlines, to provide support and give employees the opportunity to ask questions or report concerns. The most effective ethics hotlines operate on an anonymous basis and are supported 24 hours a day, 365 days a year. Approximately 50 percent of hotline calls occur at night or on the weekends. Many times troubling ethical issues can cause people to lose sleep and can occupy their thoughts during their free time.[37] Although there is always some concern that employees may misreport a situation or abuse a hotline to retaliate against a coworker, hotlines have become widespread, and employees do use them. An easy-to-use hotline or help desk can serve as a safety net that increases the chance of detecting and responding to unethical conduct in a timely manner. Hotlines serve as a central contact point where critical comments, dilemmas, and advice can be assigned to the person most appropriate for handling a specific case.[38] Employees often prefer to deal with ethical issues through their supervisors or managers or try to resolve the matter directly before using an anonymous reporting system such as a hotline.[39]

Companies are increasingly using firms that provide professional case-management services and software. Software is becoming popular because it provides reports of employee concerns, complaints, or observations of misconduct that can then be tracked and managed. Thus the company can track investigations, analysis, resolutions, and documentation of misconduct reports. This system helps prevent lawsuits and can help a company learn about and analyze ethical lapses. However, it is important for companies to choose the right software for their needs. Although only 10 to 15 percent of companies currently use some type of compliance management tool, many companies are moving toward the automated process that technology and software provide.

If a company is not making progress toward creating and maintaining an ethical culture, it needs to determine why and take corrective action, either by enforcing current standards more strictly or by setting higher standards. Corrective action may involve rewarding employees who comply with company policies and standards and punishing those who do not. When employees abide by organizational standards, their efforts should be acknowledged through public recognition, bonuses, raises, or some other means. On the other hand, when employees violate organizational standards, they must

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be reprimanded, transferred, docked, suspended, or even fired. If a firm fails to take corrective action against unethical or illegal behavior, the inappropriate behavior is likely to continue. In the Ethics Resource Center Survey, the biggest reason employees gave for not reporting observed misconduct was that they were skeptical that their report would make a difference. The second most common reason was fear of retaliation.[40] However, new laws and court rulings are making it more difficult for businesses to engage in retaliation. The Supreme Court has ruled that an employee can even sue if a close associate or relative is fired by an employer in retaliation for reporting misconduct such as discrimination.[41]

Consistent enforcement and necessary disciplinary action are essential to a functional ethics or compliance program. The ethics officer is usually responsible for implementing all disciplinary actions for violations of the firm's ethical standards. Many companies are including ethical compliance in employee performance evaluations. During performance evaluations, employees may be asked to sign an acknowledgment that they have read the company's current ethics guidelines. The company must also promptly investigate any known or suspected misconduct. The appropriate company official, usually the ethics officer, needs to make a recommendation to senior management on how to deal with a particular ethical infraction. In some cases, a company may be required to report substantiated misconduct to a designated government or regulatory agency so as to receive credit. Under the FSGO, such credit for having an effective compliance program can reduce fines.[42]

Efforts to deter unethical behavior are important to companies' long-term relationships with their employees, customers, and community. If the code of ethics is aggressively enforced and becomes part of the corporate culture, it can effectively improve ethical behavior within an organization. If a code is not properly enforced, however, it becomes mere window dressing and will accomplish little toward improving ethical behavior and decision making.

Continuous Improvement of an Ethics Program

Improving a system that encourages employees to make more ethical decisions differs little from implementing any other type of business strategy. Implementation requires designing activities to achieve organizational objectives using available resources and given existing constraints. Implementation translates a plan for action into operational terms and establishes a means by which an organization's ethical performance will be monitored, controlled, and improved. Figure 8.3 indicates that organizations are more likely to have comprehensive ethics and compliance programs as they grow larger. This fact is in part due to increased resources, but also undoubtedly to increased stakeholder responsibilities and liabilities.

A firm's ability to plan and implement ethical business standards depends in part on how it structures resources and activities to achieve its ethical objectives. People's attitudes and behavior must be guided by a shared commitment to the business rather than by mere obedience to traditional managerial authority. Encouraging diversity of perspectives, disagreement, and the empowerment of people helps align the company's leadership with its employees.

If a company determines that its ethical performance has been less than satisfactory, executives may want to change how certain kinds of decisions are made. For example,

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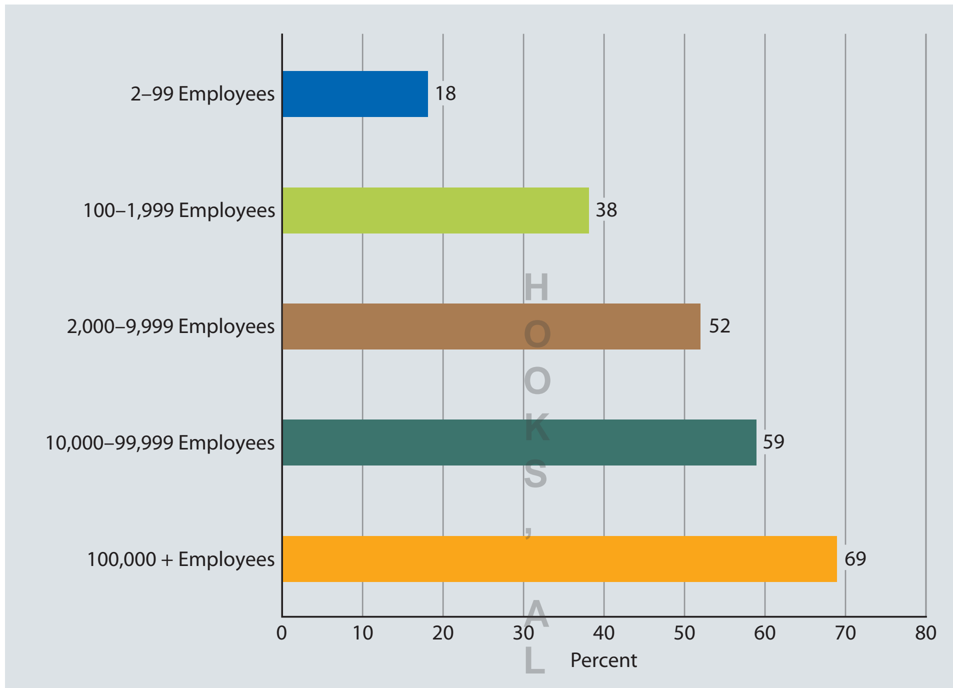
FIGURE 8.3 Percentage of Employees Recognizing Own Companies as Having Comprehensive Ethics Programs Increases with Company Size



Source: *National Business Ethics Survey 2007* (Arlington, VA: Ethics Resource Center, 2007), 35.

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a decentralized organization may need to centralize key decisions, at least for a time, so that upper managers can ensure that these decisions are made in an ethical manner. Centralization may reduce the opportunities that lower-level managers and employees have to make unethical decisions. Executives can then focus on initiatives for improving the corporate culture and infusing more ethical values throughout the firm by rewarding positive behavior and sanctioning negative behavior. In other companies, decentralizing important decisions may be a better way to attack ethical problems so that lower-level managers who are familiar with the local business environment and local culture and values can make more decisions. Whether the ethics function is centralized or decentralized, the key need is to delegate authority in such a way that the organization can achieve ethical performance.

Common Mistakes in Designing and Implementing an Ethics Program

Many business leaders recognize that they need to have an ethics program, but few take the time to answer fundamental questions about the goals of such a program. As we mentioned previously, some of the most common program objectives are to deter and detect unethical behavior as well as violations of the law; to gain competitive advantages through improved relationships with customers, suppliers, and employees; and, especially for multinational

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corporations, to link employees through a unifying and shared corporate culture. Failure to understand and appreciate these goals is the first mistake that many firms make when designing ethics programs.

A second mistake is not setting realistic and measurable program objectives. Once a consensus on objectives is reached, companies should solicit input through interviews, focus groups, and survey instruments. Finding out how employees might react in a particular situation can help companies better understand how to correct unethical or illegal behavior either reactively or proactively. Research suggests that employees and senior managers often know that they are doing something unethical but rationalize their behavior as being "for the good of the company." As a result, ethics program objectives should contain some elements that are measurable.[43]

> "Maintaining an ethical culture may be impossible if CEOs and other top officers do not support an ethical culture."

The third mistake is senior management's failure to take ownership of the ethics program. Maintaining an ethical culture may be impossible if CEOs and other top officers do not support an ethical culture. As discussed earlier in this chapter, upper-level managers, including chief financial officers and chief marketing officers, may have greater insensitivity to the needs of all stakeholders because of the pressure they feel for financial performance. These top managers may be more vulnerable to pressures placed on them to push employees to engage in unethical activities and thereby become more competitive. It is for this reason that recent amendments to the FSGO suggest that ethics officers should report to the board of directors rather than the general counsel. The board of directors should have ultimate responsibility and oversight to create an organizational ethical culture.

The fourth mistake is developing program materials that do not address the needs of the average employee. Many compliance programs are designed by lawyers to ensure that the company is legally protected. These programs usually yield complex "legalese" that few within the organization can understand. To avoid this problem, ethics programs—including codes of conduct and training materials—should include feedback from employees from across the firm, not just the legal department. Including a question-and-answer section in the program; referencing additional resources for guidance on key ethical issues; and using checklists, illustrations, and even cartoons can help make program materials more user-friendly.

The fifth common mistake made in implementing ethics programs is transferring an "American" program to a firm's international operations. In multinational firms, executives should involve overseas personnel as early as possible in the process in order to help foster an understanding of the company's values and to minimize potential for misconduct stemming from misunderstandings. These aims can be accomplished by developing an inventory of common global management practices and processes and examining the corporation's standards of conduct in light of these international standards.

A final common mistake is designing an ethics program that is little more than a series of lectures. In such cases, participants typically recall less than 15 percent the day after the training. A more practical solution is to allow employees to practice the skills they learn through case studies or small-group exercises.

A firm cannot succeed solely by taking a legalistic compliance approach to ethics. Top managers must seek to develop high ethical standards that serve as barriers to illegal conduct. Although an ethics program should help reduce the possibility of penalties and negative public reaction to misconduct, a company must want to be a good corporate citizen and must recognize the importance of ethics to success in business.

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SUMMARY

Ethics programs help sensitize employees to potential legal and ethical issues within their work environments. To promote ethical and legal conduct, organizations should develop ethics programs, establishing, communicating, and monitoring ethical values and legal requirements that characterize the firms' history, culture, industry, and operating environment. Without such programs and uniform standards and policies of conduct, it is difficult for employees to determine what behaviors a company deems acceptable.

A company must have an effective ethics program to ensure that employees understand its values and comply with its policies and codes of conduct. An ethics program should help reduce the possibility of legally enforced penalties and negative public reaction to misconduct. The main objective of the Federal Sentencing Guidelines for Organizations is to encourage companies to assess risk and then self-monitor and aggressively work to deter unethical acts and punish unethical employees. Ethics programs are organizational control systems that create predictability in employee behavior. These control systems may have a compliance orientation, which uses legal terms, statutes, and contracts that teach employees the rules and the penalties for noncompliance, or a values orientation, which consists of developing shared values.

Most companies begin the process of establishing organizational ethics programs by developing codes of conduct, which are formal statements that describe what an organization expects of its employees. Codes of conduct include a company's code of ethics and/or its statement of values. A code of ethics must be developed as part of senior management's desire to ensure that the company complies with values, rules, and policies that support an ethical culture. Without uniform policies and standards, employees will have difficulty determining what qualifies as acceptable behavior in the company.

Having a high-level manager or committee responsible for an ethical compliance program can significantly enhance its administration and oversight. Such ethics officers are usually responsible for assessing the needs and risks to be addressed in an organization-wide ethics program, developing and distributing a code of conduct or ethics, conducting training programs for employees, establishing and maintaining a confidential service to answer questions about ethical issues, making sure the company is complying with government regulations, monitoring and auditing ethical conduct, taking action on possible violations of the company's code, and reviewing and updating the code.

Successful ethics training is important in helping employees identify ethical issues and in providing them with the means to address and resolve such issues. Training can educate employees about the firm's policies and expectations, available resources, support systems, and designated ethics personnel, as well as about relevant laws and regulations and general social standards. Top executives must communicate with managers at the operations level and enforce overall ethical standards within the organization.

An effective ethics program employs a variety of resources to monitor ethical conduct and measure the program's effectiveness. Compliance with the company's ethical code and standards can be assessed through observing employees, performing internal audits and surveys, instituting reporting systems, and conducting investigations, as well as through external audits and review, as needed. Corrective action involves rewarding employees who comply with company policies and standards and punishing those who do not. Consistent enforcement and disciplinary action are necessary for a functioning ethical compliance program.

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Ethical compliance can be ensured by designing activities that achieve organizational objectives using available resources and given existing constraints. A firm's ability to plan and implement ethical business standards depends in part on its ability to structure resources and activities to achieve its objectives effectively and efficiently.

In implementing ethics and compliance programs many firms make some common mistakes, including failing to answer fundamental questions about the goals of such programs, not setting realistic and measurable program objectives, failing to have senior management take ownership of the ethics program, developing program materials that do not address the needs of the average employee, transferring an "American" program to a firm's international operations, and designing an ethics program that is little more than a series of lectures. Although an ethics program should help reduce the possibility of penalties and negative public reaction to misconduct, a company must want to be a good corporate citizen and recognize the importance of ethics to successful business activities.

IMPORTANT TERMS FOR REVIEW

compliance orientation
code of ethics
values orientation
statement of values
code of conduct
ethics officers

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RESOLVING ETHICAL BUSINESS CHALLENGES*

Jim, now in his fourth year with Cinco Corporation, was made a plant manager three months ago after completing the company's management-training program. Cinco owns pulp-processing plants that produce various grades of paper from fast-growing, genetically altered trees. Jim's plant, Cinco's smallest and oldest, is located in upstate New York near a small town. It employs between 100 and 175 workers, mostly from the nearby town. In fact, the plant boasts about employees whose fathers and grandfathers have also worked there. Every year Cinco holds a Fourth of July picnic for the entire town.

Cinco's policy is to give each manager a free hand in dealing with employees, the community, and the plant itself. Its main measure of performance is the bottom line, and employees are keenly aware of this fact.

Like all pulp-processing plants, Cinco is located near a river. Because of the plant's age, much of its equipment is outdated. Consequently, it takes more time and money to produce paper at Jim's plant than at Cinco's newer plants. Cinco has a long-standing policy of breaking in new managers at this plant to see if they can manage a work force and a mill efficiently and effectively. The tradition is that a manager who does well with the upstate New York plant will be transferred to a larger, more modern one. As a result, the plant's workers have had to deal with many managers and have become hardened and insensitive to change. In addition, most of the workers are older and more experienced than their managers, including Jim.

In his brief tenure as plant manager, Jim had learned much about the business from his workers. Jim's secretary, Ramona, made sure that reports were prepared correctly, that bills were paid, and that Jim learned how to perform his tasks. Ramona has been with the plant for so long that she has become a permanent fixture. Jim's three foremen are all in their late 40s and keep things running smoothly. Jim's wife, Elaine, is having a difficult time adjusting to life in upstate New York. Speaking with other managers' wives, she learned that the "prison sentence," as she called it, typically lasted no longer than two years. She had a large calendar in the kitchen and crossed off each day they were there.

One morning as Jim came into the office, Ramona didn't seem her usual stoic self.

"What's up?" Jim asked her.

"You need to call the EPA," she replied. "It's not really important. Ralph Hoad from the EPA said he wanted you to call him."

When Jim made the call, Ralph told him the mill's waste disposal into the river exceeded Environmental Protection Agency (EPA) guidelines, and he would stop by next week to discuss the situation. Jim hung up the phone and asked Ramona for the water sample results for the last six months from upstream, from downstream, and at the plant. After inspecting the data and comparing them with EPA standards, he found no violations of any kind. He then ordered more tests to verify the original data. The next day Jim compared the previous day's tests with the last six months' worth of data and still found no significant differences and no EPA violations. As he continued to look at the data, however, something stood out on the printouts that he hadn't noticed before. All the tests had been done on the first or second shifts. Jim called the foremen of the two shifts to his office and asked if they knew what was going on. Both men were extremely evasive in their answers and referred him to the third-shift foreman. When Jim phoned him, he, too, was evasive and said not to worry—that Ralph would explain it to him.

That night Jim decided to make a spot inspection of the mill and test the wastewater. When he arrived at the river, he knew by the smell that something was very wrong. Jim immediately went back to the mill and demanded to know what was happening. Chuck, the third-shift foreman, took Jim down to the lowest level of the plant. In one of the

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many rooms stood four large storage tanks. Chuck explained to Jim that when the pressure gauge reached a certain level, a third-shift worker opened the valve and allowed the waste to mix with everything else.

"You see," Chuck told Jim, "the mill was never modernized to meet EPA standards, so we have to divert the bad waste here; twice a week it goes into the river."

"Who knows about this?" asked Jim.

"Everyone who needs to," answered Chuck.

When Jim got home, he told Elaine about the situation. Elaine's reaction was, "Does this mean we're stuck here? Because if we are, I don't know what I'll do!" Jim knew that all the managers before him must have had the same problem. He also knew that there would be no budget for installing EPA-approved equipment for at least another two years. The next morning Jim checked the EPA reports and was puzzled to find that the mill had always been in compliance. There should have been warning notices and fines affixed, but he found nothing.

That afternoon Ralph Hoad stopped by. Ralph talked about the weather, hunting, fishing, and then he said, "Jim, I realize you're new. I apologize for not coming sooner, but I saw no reason to because your predecessor has taken care of me until this month."

"What do you mean?" Jim asked.

"Ramona will fill you in. There's nothing to worry about. I know no one in town wants to see the mill close down, and I don't want it to either. There are lots of memories in this old place. I'll stop by to see you in another couple of months." With that, Ralph left.

Jim asked Ramona about what Ralph had said. She showed him a miscellaneous expense of $100 a month in the ledgers. "We do this every month," she told him.

"How long has this been going on?" asked Jim.

"Since the new EPA rules," Ramona replied. She went on to clarify Jim's alternatives. Either he could continue paying Ralph, which didn't amount to much, or he could refuse to pay, which would mean paying EPA fines and a potential shutdown of the plant. As Ramona put it, "Headquarters only cares about the bottom line. Now, unless you want to live here the rest of your life, the first alternative is the best for your career. The last manager who bucked the system lost his job. The rule in this industry is that if you can't manage Cinco's upstate New York plant, you can't manage. That's the way it is."

QUESTIONS | EXERCISES

1. Identify the ethical and legal issues of which Jim needs to be aware.
2. Discuss the advantages and disadvantages of each decision that Jim could make.
3. Identify the pressures that have brought about the ethical and legal issues at hand.
4. What is Jim's place in the power structure at the plant?

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CHECK YOUR EQ

Check your EQ, or Ethics Quotient, by completing the following. Assess your performance to evaluate your overall understanding of the chapter material.

1. A compliance program should be deemed effective if it addresses the seven minimum requirements for ethical compliance programs. **Yes** **No**
2. The accountability and responsibility for appropriate business conduct rests with top management. **Yes** **No**
3. Ethical compliance can be measured by observing employees as well as through investigating and reporting mechanisms. **Yes** **No**
4. The key goal of ethics training is to help employees identify ethical issues. **Yes** **No**
5. An ethical compliance audit is designed to determine the effectiveness of ethics initiatives. **Yes** **No**

ANSWERS **1. No.** An effective compliance program has the seven elements of a compliance program in place and goes beyond those minimum requirements to determine what will work in a particular organization. **2. Yes.** Executives in an organization determine the culture and initiatives that support ethical behavior. **3. Yes.** Sometimes external monitoring is necessary, but internal monitoring and evaluation are the norm. **4. No.** It is much more than that—it involves not only recognition but also an understanding of the values, culture, and rules in an organization as well as the impact of ethical decisions on the company. **5. Yes.** It helps in establishing the code and in making program improvements.

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CHAPTER 9

MANAGING AND CONTROLLING ETHICS PROGRAMS

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CHAPTER OBJECTIVES

- To define ethics auditing
- To identify the benefits and limitations of ethics auditing
- To examine the challenges of measuring nonfinancial performance
- To explore the stages of the ethics-auditing process
- To understand the strategic role of the ethics audit

CHAPTER OUTLINE

Implementing Ethics Programs

The Ethics Audit

Benefits of Ethics Auditing

Ethical Crisis Management and Recovery

Measuring Nonfinancial Performance

Risks and Requirements in Ethics Auditing

The Auditing Process

Secure Commitment of Top Managers and Board of Directors

Establish a Committee to Oversee the Ethics Audit

Define the Scope of the Audit Process

Review Organizational Mission, Values, Goals, and Policies and Define Ethical Priorities

Collect and Analyze Relevant Information

Verify the Results

Report the Findings

The Strategic Importance of Ethics Auditing

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AN ETHICAL DILEMMA*

Chantal had been with Butterfly Industries for 13 years. She started out as an assistant buyer and was later promoted to buyer. She threw herself into her work, and within a few years she had moved into the corporate offices.

During Chantal's tenure, Butterfly Industries grew from fewer than 500 employees to more than 35,000. The company had expanded all over the world and opened offices on every continent; it had nearly exclusive arrangements with suppliers from six different countries. Such rapid growth eroded the freedoms of a small firm. So many employees, with different cultures, languages, and time zones, from so many countries, each with its own political realities, made corporate life much more complicated.

To Chantal, it seemed that the firm had grown at a whirlwind pace, and sometimes she thought that whirlwind had become an ugly black cloud. She heard, for example, that some of Butterfly's suppliers in Puerto Rico mistreated their workers. In other foreign locations, Butterfly's products were bringing changes to the environment, as well as to local culture and gender roles. Because Butterfly's workers tended to be women, children were being left to fend for themselves. In some Latin American countries, husbands were angry because their wives earned more than they did. Then there were the rumors that retailers in some countries were selling Butterfly products without adequate service—or worse, diluting the products and selling them as "full strength."

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After Butterfly went public, Chantal's sense of foreboding grew. Employees at headquarters scrambled to satisfy shareholders' demands for specific information about products, projected earnings, employee benefit policies, and equal employment opportunity records. Chantal was also troubled that so many of the corporate people were men; only she and one other woman were directly involved in the inner workings of the increasingly complex firm.

Six months ago, Chantal began hearing that some plant employees were suffering pay cuts while others weren't. In some cases, employees who had been working for Butterfly for 15 years were been cut to 36-hour workweeks, losing their full-time benefits. She began to notice political alliances being formed among marketing, finance, manufacturing, and corporate headquarters. Because each plant operated as an independent profit-making entity, each was guarded in its communication with other plants, knowing that if it could increase its profits it could also increase overall pay.

Chantal was not the only one to recognize that Butterfly needed guidance in a variety of areas, but no one had stepped forward. Then Butterfly's president, Jermaine, asked Chantal to lunch. This was not unusual, but the conversation soon took a significant twist that Chantal was unprepared for.

"Chantal, you've been with the company for 13 years now, right?" asked Jermaine.

"Yes, that's right," Chantal answered.

"You know as well as anyone that I haven't kept pace with the growth," Jermaine continued with a mixture of sadness and determination. "When I founded this company, I could tell a few staffers to check out an idea, and several weeks later we'd talk about whether it would work. There was a time when I knew every employee, and even their families, but not anymore. Chantal, I think Butterfly has outgrown my style of management. What this company needs is a comprehensive set of rules and guidelines for every part of the company. I need to delegate more. That's why I wanted to talk to you."

Chantal asked, "Jermaine, what are you saying to me?"

"Chantal, I've always been impressed with your work ethic and your sense of values. You know this company and its culture so well. I know you've heard some of the same rumors, so we both know that all is not well at Butterfly. What I'd like is for you to become the head of Butterfly's ethics committee. Of course, we don't yet have an ethics committee, so that's where you come in."

"Me?" Chantal asked with surprise.

"Yes, you. If you're willing, I want you to create this entity and run it so that we all can be proud of Butterfly again. So that people inside and outside the company will know that we stand for what is right. You will be promoted to vice president, your salary will be doubled, and you can select your own team. Chantal, this is your chance to make a huge difference. What's your answer?" asked Jermaine.

Chantal hesitated for a moment and then said, "Yes."

"Great! I knew I could count on you. The first thing I need is a proposed outline of the responsibilities of the new ethics committee, enforcement procedures—the works—and I want it in two weeks along with a list of people for the committee."

That night, Chantal began to plan.

QUESTIONS | EXERCISES

1. Prioritize the issues that Butterfly needs to deal with. How can an ethics program address these issues?
2. Develop an outline of who should be on the new ethics committee and describe what the committee's first steps should be toward implementing an effective ethics program.
3. Should the new ethics committee commission an ethics audit? If yes, when should the audit be conducted? If no, why not?

*This case is strictly hypothetical; any resemblance to real persons, companies, or situations is coincidental.

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In Chapter 8, we introduced the idea of ethics programs as a way for organizations to improve ethical decision making and conduct in business. To properly implement these programs and ensure their effectiveness, companies need to measure

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their impact. Increasingly, companies are applying the principles of auditing to ascertain whether their ethics codes, policies, and corporate values are having a positive impact on the firm's ethical conduct. These audits can help companies identify risks and areas of noncompliance with laws and company policies as well as other areas that need improvement. An audit should provide a systematic and objective survey of the firm's ethical culture and values.

We begin this chapter by examining some of the requirements of a successful ethics program. We then discuss the concept of an ethics audit as a way to execute such a program. We define the term *ethics audit* and explore its relationship to a social audit. Next, we examine the benefits and limitations of this implementation tool, especially with regard to avoiding a management crisis. We consider the challenges of measuring nonfinancial ethical performance, and review evolving standards from AA1000 and the Open Compliance Ethics Group. We then describe our framework for the steps of an ethics audit, including securing the commitment of directors and top managers; establishing a committee to oversee the audit; defining the scope of the audit process; reviewing the firm's mission, values, goals, and policies and defining ethical priorities; collecting and analyzing relevant information; and verifying and reporting the results. Finally, we consider the strategic importance of ethics auditing.

IMPLEMENTING ETHICS PROGRAMS

Developing an effective business ethics program requires organizations to cope with the realities of implementing such a program. Implementation requires executing specific actions that will ensure the achievement of business ethics objectives. The organization must have ways of managing, evaluating, and controlling business ethics programs. Five items in particular can have a significant impact on whether an ethics program is successful: (1) the content of the company's code of ethics, (2) the frequency of communication regarding the ethical code and program, (3) the quality of communication, (4) senior management's ability to successfully incorporate ethics into the organization, (5) and local management's ability to do the same.[1] If an organization has a culture that is more focused on planning than on implementation, employees may come to view unethical conduct as acceptable behavior. Without proper controls in place, lying to customers, manipulating prices, abusive behavior, and misuse of organizational resources can become a part of some employees' conduct.

Viewing a business ethics program as a part of strategic planning and management activities is critical to the success of any firm. Some companies still do not understand that ethics is a critical aspect of business strategy in action. This misunderstanding stems from a belief that the ethics of employees is primarily an individual matter, and not the responsibility of managers. The nature of ethics programs in corporate America is to determine risks, develop policies and codes of conduct, and require specific standards of conduct. However, in order to do the right thing and know when to say no or ask for assistance in gray areas, employees must have a strong sense of personal ethics.

Shared values among employees are the glue of successful management as well as of business ethics programs. When business ethics programs help to align and direct employees' activities toward an ethical culture, employees will feel a commitment to the long-term ethical progress of the firm. Green Mountain Coffee Roasters, Inc., is a firm

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that has been recognized for its emphasis on socially responsible business activities. It has consistently earned a place in *Business Ethics/CR Magazine*'s "100 Best Corporate Citizens" and was honored by the Society for Human Resource Management for its ethical practices.[2] The firm focuses on ethical management and implementation with open communication. It uses a process called the "after-action review" that asks four questions: What did we set out to do? What happened? Why did it happen? What are we going to do about it?

Formal controls for business ethics include input controls such as the proper selection of employees, effective ethics training and strong structural systems (including communication systems). In Chapter 8 we discussed internal control systems whereby employees can report misconduct. Ethics assistance lines, sometimes called hotlines, provide support and give employees the opportunity to get assistance, ask questions, or report concerns. Another internal control system that can improve ethical assistance is an ethics help desk. An ethics help desk is a point of contact within an organization where employees and managers can bring their concerns and receive assistance from the most appropriate person in the firm to handle the situation. For this model to be successful, the help desk must be supportive of employees, be easily accessible, and have simple procedures for employees to follow when they express concerns.[3]

Process controls include management's commitment to the ethics program and to the methods or system for ethics evaluation. These methods might involve daily coaching for managers and employee reminders regarding appropriate ethical conduct. The best way to provide leadership on ethics is to set a good example, and there are many examples of effective corporate leaders who promote ethics from the top. For example, Jeffrey Swartz, the CEO of Timberland, has won recognition as a strong and ethical corporate leader. Swartz has expanded Timberline's Green Index—a measurement that shows the product's environmental impact based on climate impact, chemicals used, and resource consumption—to include its entire footwear collection. He has also announced his company's commitment to plant 5 million trees in a five-year period. Swartz exhibits good leadership qualities in the care he shows his employees and in his willingness to take responsibility for past mistakes.[4]

Output controls involve comparing standards with actual behavior. One of the most popular methods of evaluating ethical performance is an ethics audit. The primary purpose of an ethics audit is to identify the risks and problems in outgoing activities and plan the necessary steps to adjust, correct, or eliminate these ethical concerns. Regardless of the complexity of a firm's ethics program, an ethics audit is critical to the program's success; therefore, a major part of this chapter focuses on how such audits should be conducted. The Federal Sentencing Guidelines for Organizations' recent amendment suggests that the results of an ethics audit be reported directly to the board of directors. Such direct reporting would prevent the CEO or another top officer from covering up misconduct.

This chapter will help complete your understanding of how organizational ethics is managed and controlled to create an effective ethics program. Although you may never be in charge of such a program, as a manager or employee you will be part of it. The greater your understanding of the role and function of the various parts of the program, the more effective you will be in engaging and guiding others to make ethical decisions. Business ethics in an organization is not simply a personal matter that is based on your individual values. You will be responsible, both ethically and legally, for engaging in ethical conduct and reporting the unethical conduct of others in your organization.

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THE ETHICS AUDIT

An **ethics audit** is a systematic evaluation of an organization's ethics program and performance to determine whether it is effective. A major component of the ethics program described in Chapter 8, the ethics audit includes "regular, complete, and documented measurements of compliance with the company's published policies and procedures."[5] As such, the audit provides an opportunity to measure conformity to the firm's desired ethical standards. An audit can even be a precursor to setting up an ethics program, as it identifies the firm's ethical standards as well as its existing policies and risk areas. Recent legislation and FSGO amendments encourage greater ethics auditing as companies attempt to demonstrate to various stakeholders that they are abiding by the law and have established programs to improve ethical decision making. While companies are not required to report the results of their audits to the public, some firms, such as New Belgium Brewing, do report the results of audits in areas such as employment practices, sustainability efforts, and community outreach.

The concept of ethics auditing emerged from the movement to evaluate and report on companies' broader social responsibility initiatives, particularly with regard to sustainability. An increasing number of companies are auditing their social responsibility programs and reporting the results so as to document their efforts to be more responsible to various interested stakeholder groups. A **social audit** is the process of assessing and reporting on a business's performance in fulfilling the economic, legal, ethical, and philanthropic responsibilities expected of it by its stakeholders.[6] Social reports often discuss issues related to a firm's performance in the four dimensions of social responsibility as well as specific social responsibility and ethical issues such as employment issues, community economic development, volunteerism, and environmental impact.[7] In contrast, ethics audits focus more narrowly on a firm's ethical and legal conduct. However, an ethics audit can be a component of a social audit; indeed, many companies include ethical issues in their social audits. Walmart, for example, includes ethical performance in its Sustainability Report.[8]

Regardless of the breadth of the audit, ethics auditing is a tool that companies can employ to identify and measure their ethical commitment to stakeholders. Employees, customers, investors, suppliers, community members, activists, the media, and regulators are increasingly demanding that companies be ethical and accountable for their conduct. In response, businesses are working to incorporate accountability into their actions, from long-term planning, everyday decision making, and rethinking processes for corporate governance and financial reporting to hiring, retaining, and promoting employees and building relationships with customers. The ethics audit provides an objective method for demonstrating a company's commitment to improving strategic planning, including its compliance with legal and ethical standards and standards of social responsibility. The auditing process is important to business because it can improve a firm's performance and effectiveness, increase its attractiveness to investors, improve its relationships with stakeholders, identify potential risks, and decrease the risk of misconduct and adverse publicity that could harm its reputation.[9] As we discussed in Chapter 1, the "World's Most Ethical Companies" have shown better financial performance than the firms in the general stock indexes.

> **"Ethics auditing is a tool that companies can employ to identify and measure their ethical commitment to stakeholders."**

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Ethics auditing employs procedures and processes similar to those found in financial auditing to create an objective report of a company's performance. As in an accounting audit, someone with expertise from outside the organization may be chosen to conduct an ethics audit. Although the standards used in financial auditing can be adapted to provide an objective foundation for ethics reporting, there are significant differences between the two types of audits. Whereas financial auditing focuses on all systems related to money flow and on financial assessments of value for tax purposes and managerial accountability, ethics auditing deals with the internal and broad external impact of an organization's ethical performance. Another significant difference is that ethics auditing is not usually associated with regulatory requirements, while financial audits are required of public companies that issue securities. Because ethics and social audits are voluntary, there are fewer standards that a company can apply with regard to reporting frequency, disclosure requirements, and remedial actions that it should take in response to results. This may change as more companies develop ethics programs in the current regulatory environment, in which regulatory agencies support requiring boards of directors to oversee corporate ethics. If boards are to track the effectiveness of ethics programs, audits will be required. In addition, nonfinancial auditing standards are developing, with data available for benchmarking and comparing a firm's nonfinancial ethical performance with its own past performance and with the performance of other firms.

BENEFITS OF ETHICS AUDITING

There are many reasons why companies choose to analyze, report on, and improve their ethical conduct. Assessment of an organization's ethical culture is necessary to improve ethical performance and to document in legal proceedings that a firm has an effective ethics program. Companies can use ethical audits to detect ethical misconduct before it becomes a major problem, and audits provide evidence of a firm's attempts to identify and deal with major ethical risks. ATM manufacturer Diebold, Inc., was charged by the Securities and Exchange Commission with manipulating earnings from 2002 to 2007 to meet its financial forecasts. This manipulation is estimated to have inflated Diebold's reported earnings by $127 million. Diebold agreed to settle with the SEC for $25 million, and the company's former chief executive agreed to pay back $470,000.[10] Such accounting scandals and legal and ethical transgressions have encouraged companies to better account for their actions in a wide range of areas, including corporate governance, ethics programs, customer relationships, employee relations, environmental policies, and community involvement.

One company may want to achieve the most ethical performance possible, whereas another may use an ethics audit merely to project a good image to hide its corrupt culture. Top managers might use an ethics audit to identify ethical problems in their companies, but identification alone does not mean that they will take steps to correct these lapses through punishments or sanctions.[11] Without appropriate action on the part of management, an ethics audit can be mere lip service intended to enhance the firm's reputation without actually improving its ethical conduct. Other firms might conduct ethics audits in an attempt to comply with the Federal Sentencing Guidelines for Organizations, (FSGO) requirements that the board of directors oversee the discovery of ethical risk, design and implement an ethics program, and evaluate performance. Some companies view the auditing process as tied to continuous improvement, which is closely related to improved financial performance. Companies' reasons for supporting the FSGO are complex and diverse. For

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example, it is common for firms to conduct audits of business practices with legal ramifications such as employee safety, environmental impact, and financial reporting. Although these practices are important to a firm's ethics and social responsibility, they are also legally required and therefore constitute the minimum level of commitment. However, because stakeholders are demanding increased transparency and taking a more active role through external organizations that represent their interests, government regulators are calling on companies to improve their ethical conduct and make more decisions based on principles rather than on laws alone.

Measuring the ethical work climate of an organization is one way to learn about its ethical culture. While most measurements of ethical climate are conducted by academic researchers, some firms are becoming proactive in working with consultants to measure their ethical climate. Some measures of ethical climate include collective ethical sensitivity (empathetic concern and awareness), collective character, collective judgment (focus on others and focus on self), and collective moral motivation.[12] These measures can be used to help evaluate changes in a firm's ethical culture after the development of ethics programs.

The auditing process can highlight trends, improve organizational learning, and facilitate communication and working relationships.[13] Auditing can also help companies assess the effectiveness of their programs and policies, which often improves their operating efficiencies and reduces costs. Information from audits and reports can allow a company to ensure that it is achieving the greatest possible impact with available resources.[14] The process of ethics auditing can also help an organization identify potential risks and liabilities and improve its compliance with the law. Furthermore, the audit report may help document a firm's compliance with legal requirements as well as demonstrate its progress in areas where it previously failed to comply, for example by describing the systems it is implementing to reduce the likelihood of a recurrence of misconduct.[15]

For organizations, one of the greatest benefits of the auditing process is improved relationships with stakeholders who desire greater transparency. Many stakeholders have become wary of corporate public relations campaigns. Verbal assurances by corporate management are no longer sufficient to gain stakeholders' trust. An ethics audit could have saved Countrywide Financial if liar loans and the manipulation of borrowers' financial data had been identified earlier. When companies and their employees, suppliers, and investors trust each other, the costs of monitoring and managing these relationships are lower. Companies experience less conflict with these stakeholders, which results in a heightened capacity for innovation and collaboration.

Because of these benefits shareholders and investors have welcomed the increased disclosure that comes with corporate accountability. Table 9.1 indicates the top challenges that CEOs will be facing in the future. Keeping pace with regulation, protecting against risks, and reputation management are three of the top 10 challenges. These issues can be considered major risks associated with managing and controlling ethics programs. Therefore, they represent key areas that could be important in an ethics audit. A growing number of investors are considering nonfinancial measures—such as the existence of ethics programs, legal compliance, board diversity and independence, and other corporate governance issues like CEO compensation—when they analyze the quality of current and potential investments. Research suggests that investors may be willing to pay higher prices for the stock of companies that they deem to be accountable,[16] such as stock from *Fortune*'s "World's Most Admired Companies," including Adobe Systems, Whirlpool, Berkshire Hathaway, Google, Marriott International, Procter & Gamble, 3M, Deere, UPS, and BMW, who have generally avoided major ethical disasters.[17]

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TABLE 9.1 Top Challenges for CEOs

1.	Managing growth
2.	Employee turnover
3.	Customer relationships
4.	Social media
5.	Regulatory issues
6.	Risk management
7.	Globalization
8.	Reputation
9.	Technology competence
10.	Competitive advantage

Source: Adapted from Sheryl Nance-Nash, "Top Challenges for CEOs in 2011," *Daily Finance*, December 15, 2010, http://www.dailyfinance.com/story/top-10-challenges-for-corporate-ceos-in-2011/19760107/ (accessed March 23, 2011).

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However, even companies that have experienced legal issues or have had their ethics questioned can make a comeback. Walmart CEO Mike Duke has been recognized for his leadership in the arena of business ethics as a result of his investment in sustainable supply chain practices. Under his leadership, Walmart has set forth an ambitious initiative to "green" its supply chain. The company is asking its suppliers to examine the carbon lifecycle of its products and make meaningful changes in sourcing, manufacturing, packaging, and transporting products. Walmart also plans to reduce greenhouse gas emissions from its supply chain by 20 million metric tons by 2015. Duke agreed that the company would invest $1 billion over the next five years to create a more sustainable supply chain. The company has strived to learn from its mistakes, settling more than 60 wage and hour abuse lawsuits. Walmart consistently ranks near the top of *Fortune*'s Most Admired Companies in spite of past ethical and legal concerns.[18]

Regular audits permit shareholders and investors to judge whether a firm is achieving the goals it has established, and whether it abides by the values that it has specified as important. Moreover, it permits stakeholders to influence the organization's behavior.[19] Increasingly, a broad range of stakeholder groups are seeking specific, often quantifiable, information from companies. These stakeholders expect companies to take a deeper look at the nature of their operations and to publicly disclose their progress and problems in addressing these issues. Some investors are using their rights as stockholders to encourage companies to modify their plans and policies to address specific ethical issues. On a broader scale, the Obama administration sought to impose limits on executive compensation of those firms seeking government financial support. The 2010 passage of the Dodd–Frank Wall Street Reform and Consumer Protection Act implemented new regulations for executive compensation. Under these new provisions, shareholders of public companies can cast advisory votes on whether they approve of the compensation awarded to top executives. Additionally, top executives must provide more disclosure on how their compensation aligns with the company's financial performance.[20]

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Ethical Crisis Management and Recovery

A significant benefit of ethics auditing is that it may help prevent crises resulting from ethical or legal misconduct, crises that can potentially be more devastating than natural disasters or technological disruptions. Just as companies develop crisis management plans to respond to and recover from natural disasters, they should also prepare for ethical disasters, which can not only result in substantial legal and financial costs but which can also disrupt routine operations, paralyze employees, reduce productivity, destroy organizational reputation, and erode stakeholder confidence. Ethical and legal crises have resulted in the demise or acquisition of a number of well-known companies including Lehman Brothers, Merrill Lynch, and Washington Mutual. Many other companies—HealthSouth, Firestone, Waste Management, Rite Aid, U.S. Foodservice, Qwest, Kmart, Mitsubishi Motors, and Archer Daniels Midland, for example—have survived ethical and legal crises but paid a high price both financially and in terms of compromised reputation and diminished stakeholder trust. In recent years, companies have spent up to $7 million a month on outside legal counsel to defend against alleged organizational wrongdoing. One study found that publicity about unethical corporate behavior lowers stock prices for at least six months.[21] For example, bribery allegations and an internal bribery probe at Avon Products, Inc., temporarily lowered its share prices because of fears that a scandal could harm operations.[22]

Organizational members who engage in questionable or even illegal conduct are guilty of ethical misconduct, and these employees can threaten the overall integrity of the organization. Top leaders in particular can magnify ethical misconduct to disastrous proportions. The misconduct of Raj Rajaratnam at the Galleon Group, Andrew Fastow at Enron, Dennis Kozlowski at Tyco, and Bernie Ebbers at WorldCom, among others, has caused financial disasters on both organizational and global levels.[23] An ethics audit can uncover rogue employees who are violating the firm's ethical standards and policies or laws and regulations.

Ethical disasters follow recognizable phases of escalation, from ethical issue recognition and the decision to act unethically to the organization's discovery of and response to the act. Appropriate anticipation of and intervention during these situations can stave off major problems. Such contingency planning assesses risks, plans for eventualities, and provides ready tools for responding to ethical crises. The process of ethical disaster-recovery planning involves assessing an organization's values, developing an ethics program, performing an ethics audit, and developing contingency plans for potential ethical disasters. The ethics audit itself provides the key to preventing ethical disasters.

Formal mechanisms should be in place to discover risk as a part of evaluating compliance and the effectiveness of ethics programs. The greatest fear of most corporate leaders is discovering misconduct or illegal activity that could be reported by the mass media, used by competitors, or prosecuted by the government. Yet this process is extremely important to the long-term well-being of an organization. While risks such as earthquakes, fires, hurricanes, and other natural disasters cannot always be determined, companies can plan for these types of disasters. Unfortunately, ethical risks are often given the lowest priority. Table 9.2 lists the wide range of approaches that companies use to manage risks. Only about one-fourth of the companies surveyed by the Open Compliance Ethics Group had a risk management committee that was separate from the audit committee as part of its board of directors. As Table 9.2 indicates, 14 percent of the firms report having no risks team at all.

> **"The greatest fear of most corporate leaders is discovering misconduct or illegal activity."**

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TABLE 9.2 How Do Corporations Manage Risk?

Incorporation of risk management into business management strategies	28%
Teams that combine business management and internal audits	25%
Independent risk management teams	26%
Risk management as part of internal audit	7%
No formal risk team or committee	14%

Source: Survey of 250 respondents conducted by the Open Compliance Ethics Group, April 2010, http://www.oceg.org/resource/oceg-one-minute-poll-how-do-you-manage-risk (accessed March 23, 2011).

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Measuring Nonfinancial Ethical Performance

Although much of the regulation of corporate ethics and compliance is focused on financial measures, to truly have integrity, an organization also has to focus on nonfinancial areas of performance. The word *integrity* in this context implies a balanced organization that not only makes ethical financial decisions but also is ethical in the more subjective aspects of its corporate culture. The Sarbanes–Oxley Act has focused on questionable accounting and the metrics that destroy shareholder value, but other models have been developed—such as Six Sigma, the Balanced Scorecard, and the triple bottom Line—to capture structural and behavioral organizational ethical performance. Six Sigma is a methodology designed to manage process variations that cause defects, defined as unacceptable deviations from the mean or target, and to systematically work toward managing variation to eliminate those defects. The objective of Six Sigma is to deliver world-class performance, reliability, and value to the end customer. The Balanced Scorecard is a management system that focuses on all the elements that contribute to organizational performance and success, including financial, customer, market, and internal processes. Its goal is to develop a broader perspective on performance factors and to foster a culture of learning and growth that improves all organizational communication. The triple bottom line provides a perspective that takes into account the social, environmental, and financial impacts of decisions made within an organization. When making an increased commitment to social responsibility, sustainability, or ethics, companies consider implementing triple bottom line reporting as a way to confirm that their investments and initiatives are supporting their organization's values and overall success. Table 9.3 provides additional detail on these three measurement tools. The purpose of a variety of measures of performance and goal achievement is to determine the quality and effectiveness of environmental, social, and ethics initiatives. Many believe that an inherent gain is realized by companies with strong ethical cultures and environmental commitments, paid in customer commitment and in avoiding the negative publicity and costs associated with wrongdoing.

The Global Reporting Initiative (GRI) has become a prominent framework that companies have adopted to report their social and sustainability progress.[24] The GRI advances sustainability reporting, which incorporates the triple bottom line factors of economic, social, and environmental indicators. The primary goal of the GRI is "the mainstreaming of disclosure on environmental, social, and governance performance."[25] Businesses can use the GRI to come up with a more standardized method of reporting nonfinancial results in a way that users of the reports can understand. Companies benefit because the GRI

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TABLE 9.3 Description of Measurement Tools

Measurement Systems	Description
Balanced Scorecard	Developed by Drs. Robert Kaplan and David Norton, the Balanced Scorecard incorporates nonfinancial performance indicators into the evaluation system to provide a more "balanced" view of organizational performance. The system uses four metrics—financial, internal business processes, learning and growth, and customer—to measure the overall performance of the firm.
Six Sigma	Six Sigma focuses on improving existing processes that do not meet quality specifications or that need to be improved as well as developing new processes that meet Six Sigma standards. To meet Six Sigma specifications, the process must not produce more than 3.4 defects per million opportunities.
Triple Bottom Line	This approach to measuring social, financial, and environmental factors (or people, places, and planet) recognizes that business has a responsibility to positively influence a variety of stakeholders, including customers, employees, shareholders, community, and the natural environment. The challenge is how to evaluate a business's social and environmental impacts, since there are no universally standard forms of measuring these criteria.

Source: "Balanced Scorecard Basics," Balanced Scorecard Institute, http://www.balancedscorecard.org/BSCResources/AbouttheBalancedScorecard/tabid/55/Default.aspx (accessed March 23, 2011); "What is Six Sigma," iSix Sigma, http://www.isixsigma.com/index.php?option=com_k2&view=item&id=1463:what-is-six-sigma?&Itemid=155 (accessed March 23, 2011); "Triple bottom line," *The Economist,* November 17, 2009, http://www.economist.com/node/14301663?story_id=14301663 (accessed March 23, 2011).

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provides tools for improving their implementation of the triple bottom line, as well as assisting with the disclosure of their progress in this area and giving them the ability to compare their sustainability efforts with those of other companies and the chance to enhance their reputation in the eyes of stakeholders. Users benefit because this standardized sustainability reporting gives them a point of comparison with other companies' sustainability initiatives.[26] GRI continually revises its framework to ensure that it remains relevant and encourages multiple stakeholders from global business, civil society, labor, and academic sectors to participate in the process.[27]

AccountAbility is an international membership organization committed to enhancing the performance of organizations and to developing the competencies of individuals in social and ethical accountability and sustainable development. Figure 9.1 illustrates the AccountAbility AA1000 framework for ethics and social responsibility. The AA1000 process standards link the definition and embedding of an organization's values to the development of performance targets and to the assessment and communication of organizational performance. Through this process, focused around the organization's engagement with stakeholders, AA1000 ties social and ethical issues into the organization's strategic management and operations. AA1000 recognizes these different traditions. It combines the terms *social* and *ethical* to refer to the systems and individual behavior within an organization, as well as to the *direct* and *indirect* impact of an organization's activities on stakeholders. *Social* and *ethical issues* (relating to systems, behavior, and impacts) are defined by an organization's values and aims, as shaped by the influence of the interests and expectations of its stakeholders and by societal norms and expectations. *Assessment* means measuring

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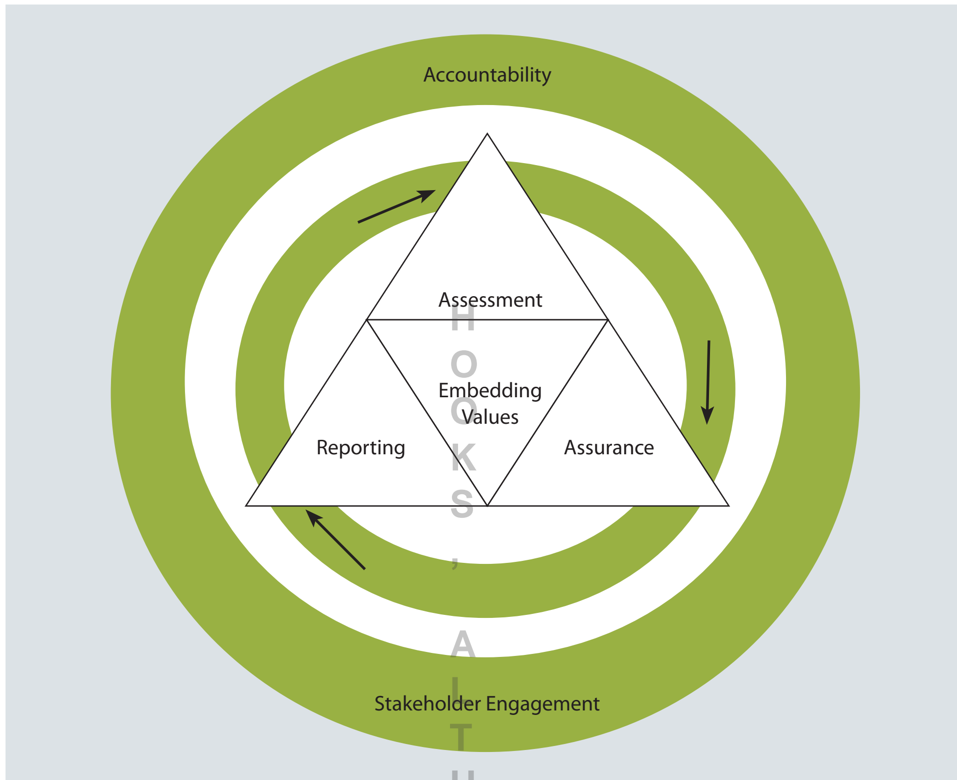
FIGURE 9.1 AA1000 Framework for Ethics and Social Accountability



Source: Adapted from AccountAbility AA1000 Series of Standards, http://www.accountability21.net/aa1000series (accessed March 12, 2009). Reprinted with permission of The Institute of Social and Ethical Accountability.

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organizational responsiveness or the extent to which an organization takes action on the basis of stakeholder engagement. This is followed by *assurance,* including control mechanisms, and then reporting to document the process. The *embedding* of an organization's values to assure performance is a continuous process.

Figure 9.2 shows the Open Compliance Ethics Group's functions of governance, risk, and compliance framework. The Open Compliance Ethics Group (OCEG) (http://www.oceg.org) has worked with more than 100 companies to create a universal framework for compliance and ethics management. The OCEG focuses on nonfinancial compliance and the more qualitative elements of internal controls. The OCEG framework deals with complex issues of compliance and solutions to address the development of organizational ethics. By establishing guidelines rather than standards, OCEG provides a tool for each company to use as it sees fit, given its size, scope, structure, industry, and other factors that create individualized needs. The OCEG guidelines and benchmarking studies can be very valuable to a firm conducting an ethics audit. Most significant is the opportunity to compare an organization's activities to those of other organizations. To this end, the OCEG has created tools and certification procedures to help businesses, such as the Burgundy Book, which assists in assessing "the design and operation of government, risk management, and compliance processes."[28] Additionally, the organization awards certification to companies

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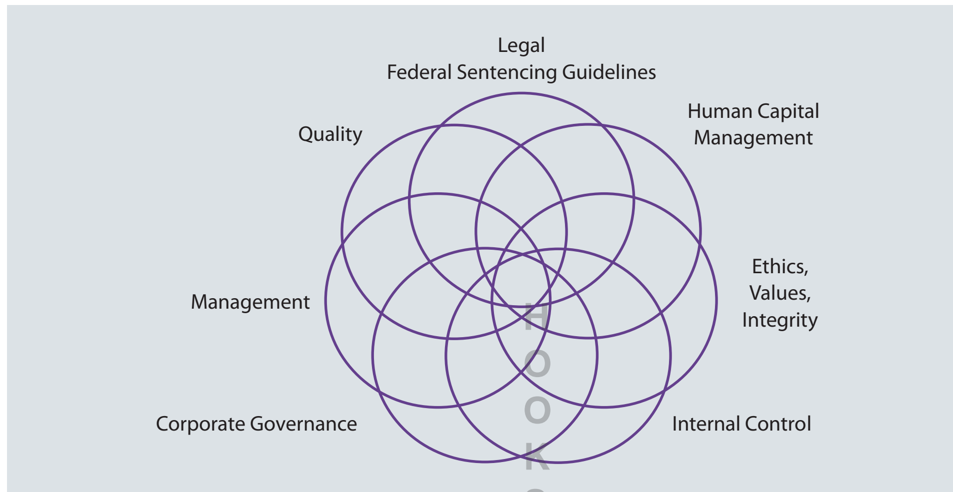
FIGURE 9.2 Roles and Functions of Risk, Management, and Compliance



and individuals that demonstrate to stakeholders that they operate at the highest standards regarding governance, risk management, and compliance.[29]

Risks and Requirements in Ethics Auditing

Although ethics audits provide many benefits for individual companies and their stakeholders, they do have the potential to create risks. For example, a firm may uncover a serious ethical problem that it would prefer not to disclose until it has remedied the situation. It may find that one or more of its stakeholders' criticisms cannot be easily addressed. Occasionally, the process of conducting an ethics audit may foster stakeholder dissatisfaction rather than stifle it. Moreover, the auditing process imposes burdens (especially with regard to record keeping) and costs for firms that undertake it. Auditing, although a prudent measure, provides no assurance that ethical risks and challenges can be avoided. Another challenge is in assessing risk and identifying standards of comparison. How can a company sufficiently analyze and manage its risks, and what goals for improvement should it develop? Some initiatives to benchmark risk assessment and best practices have begun to emerge, but this process is in its early stages.

Many companies suspected of misconduct respond to public scrutiny of their practices by conducting an ethics audit to show their concern and respond appropriately to weaknesses in their ethics programs. Companies in the public eye as a result of questionable conduct or legal violations, such as AIG, Fannie Mae, Freddie Mac, and Merrill Lynch, should conduct ethics audits to demonstrate their visible commitment to improving decision making and business conduct.

Research suggests that generating ethics and corporate social responsibility auditing procedures can be tricky because of a lack of standardization and widely accepted measures.[30] Although ethics and social responsibility are defined and perceived differently by various stakeholders, a core of minimum standards for ethical performance is evolving.

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These standards represent a fundamental step in the development of minimum ethics requirements that are specific, measurable, achievable, and meaningful to a business's impact on communities, employees, consumers, the environment, and economic systems. They help companies set measurable and achievable targets for improvement, and they form an objective foundation for reporting the firm's efforts to all direct stakeholders. Disagreements may still arise over key issues, but overall these standards should enable companies to make progress in meeting their goals. The FSGO's seven steps for effective ethical compliance, discussed in Chapters 3 and 8, as well as the Sarbanes–Oxley Act and the Dodd–Frank Act, provide standards that organizations can use in ethics auditing.

THE AUDITING PROCESS[31]

There are many questions to address when conducting an audit, such as how broad the audit should be, what standards of performance should be applied, how often the audit should be conducted, whether—and how—the audit's results should be reported to stakeholders, and what actions should be taken in response to audit results. Therefore, corporate approaches to ethics audits are as varied as their approaches to ethics programs and their responses to improving social responsibility.

It is our belief that an ethics audit should be unique to each company, reflecting its size, industry, corporate culture, and identified risks as well as the regulatory environment in which it operates. Thus, an ethics audit for a bank will differ from one for an automobile manufacturer or a food processor. Each company has different regulatory concerns and unique risks stemming from the nature of its business. For this reason, we have mapped out a framework (see Table 9.4) that is somewhat generic and that most companies can expand on when conducting their own ethics audits. The steps in our framework can also be applied to broader social audits that include specific ethical issues as well as other economic, legal, and philanthropic concerns of interest to various stakeholders. As with any new initiative, companies may choose to begin their effort with smaller, less formal audits and work up to more

TABLE 9.4 Framework for an Ethics Audit

- Secure the commitment of top managers and board of directors
- Establish a committee to oversee the ethics audit
- Define the scope of the audit process, including subject matter areas important to the ethics audit
- Review the organization's mission, policies, goals, and objectives and define its ethical priorities
- Collect and analyze relevant information in each designated subject matter area
- Have the results verified by an independent agent
- Report the findings to the audit committee and, if approved, to managers and stakeholders

Sources: These steps are compatible with the social auditing methods prescribed by Warren Dow and Roy Crowe in *What Social Auditing Can Do for Voluntary Organizations* (Vancouver: Volunteer Vancouver, July 1999), and Sandra Waddock and Neil Smith in "Corporate Responsibility Audits: Doing Well by Doing Good," *Sloan Management Review* 41 (2000): 79.

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comprehensive social audits. For example, a firm may choose to focus on primary stakeholders in its initial audit year and then expand to secondary groups in subsequent audits.

Our framework encompasses a wide range of business responsibilities and relationships. The audit entails an individualized process and outcomes for a particular firm, as it requires a careful consideration of the unique issues that face a particular organization. For example, the auditing process at Coca-Cola must consider several factors specific to that company. To ensure an effective internal audit, Coca-Cola's board of directors appoints a special audit committee whose responsibilities include a review of the company's financial statements as well as an assessment of its risk management, internal and disclosure controls, complaints procedures, and compliance programs (including the Company's Code of Business Conduct). The committee's statement of purpose is as follows:

> The Committee will represent and assist the Board in fulfilling its oversight responsibility to the shareowners and others relating to the integrity of the Company's financial statements and the financial reporting process, the systems of internal accounting and financial controls, the internal audit function, the annual independent audit of the Company's financial statements, the Company's compliance with legal and regulatory requirements, and its ethics programs as established by management and the Board, including the Company's Code of Business Conduct. The Committee shall also oversee the independent auditors' qualifications and independence. The Committee will evaluate the performance of the Company's internal audit function (responsibilities, budget and staffing) and the Company's independent auditors, including a review and evaluation of the engagement partner and coordinating partner. In so doing, it is the responsibility of the Committee to maintain free and open communication between the Committee, independent auditors, the internal auditors and management of the Company. The Committee is also responsible for producing an annual report for inclusion in the Company's proxy statement.[32]

Figure 9.3 provides a fictional example of how a corporate social responsibility structure might be organized within a well-known company. Notice that the 2010 amendments to the Federal Sentencing Guidelines for Organizations recommend that chief ethics and compliance officers report directly to the board of directors. Although this chapter presents a structure and recommendations for both general social and ethics-specific audits, there is no generic approach that will satisfy every firm's circumstances. Nevertheless, the benefits and limitations that companies derive from auditing are relatively consistent.

Secure Commitment of Top Managers and Board of Directors

The first step in conducting any audit is securing the commitment of the firm's top management and, if it is a public corporation, its board of directors. Indeed, the push for an ethics audit may come directly from the board itself in response to specific stakeholder concerns or corporate governance reforms related to the Sarbanes–Oxley Act, which suggests that boards of directors should provide oversight for *all* auditing activities. In addition, court decisions related to the FSGO hold board members responsible for the ethical and legal compliance programs of the firms they oversee. Rules and regulations associated with the Sarbanes–Oxley Act require that boards include members who are knowledgeable and qualified to oversee accounting and other types of audits to ensure that these reports are accurate and include all material information. Although a board's financial audit

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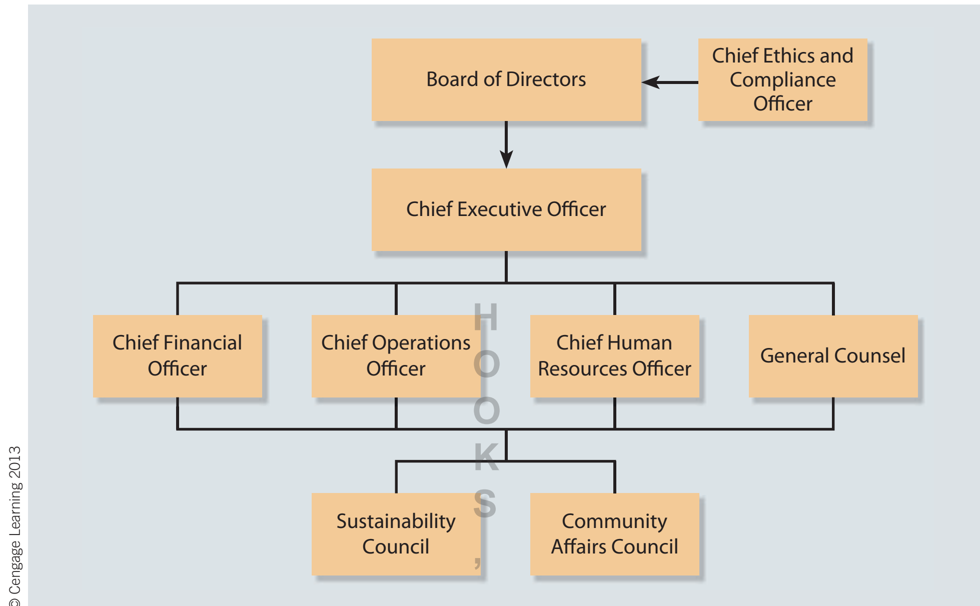
FIGURE 9.3 Model Corporate Social Responsibility Structure



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committee will examine ethical standards throughout the organization as they relate to financial matters, it will also deal with the implementation of codes of ethics for top financial officers. Many of those issues relate to such corporate governance issues as compensation, stock options, and conflicts of interest. An ethics audit can demonstrate that a firm has taken steps to prevent misconduct, which can be useful in cases where civil lawsuits blame the firm and its directors for the actions of a rogue employee.

Pressure for an audit can also come from top managers who are looking for ways to track and improve ethical performance and perhaps give their firm an advantage over competitors that are facing questions about their ethical conduct. Additionally, under the Sarbanes–Oxley Act, CEOs and CFOs may be criminally prosecuted if they knowingly certify misleading financial statements. They may request an ethics audit as a tool to help improve their confidence in their firm's reporting processes. Some companies have established a high-level ethics office in conjunction with an ethics program, and the ethics officer may campaign for an ethics audit as a way to measure the effectiveness of the firm's ethics program. Regardless of where the impetus for an audit comes from, its success hinges on the full support of top management, particularly the CEO and the board of directors. Without this support, an ethics audit will not improve the firm's ethics program or the corporate culture.

Establish a Committee to Oversee the Ethics Audit

The next step in our framework is to establish a committee or team to oversee the audit process. Ideally, the board of directors' financial audit committee would oversee the ethics audit, but this does not happen in most companies. In most firms, managers or

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ethics officers, who do not always report to the board of directors, conduct social and ethics auditing. In any case, this team should include employees who are knowledgeable about the nature and role of ethics audits, and those people should come from various departments within the firm. The team may recruit individuals from within the firm or hire outside consultants to coordinate the audit and report the results directly to the board of directors. The Ethics Resource Center, a nonprofit organization engaged in supporting ethical conduct in the public and private sector, assists companies with assessments and audits of their ethics programs.[33] As with a financial audit, an external auditor should not have other consulting or conflict-of-interest relationships with top managers or board members. Based on the best practices of corporate governance, audits should also be monitored by an independent board of directors' committee, as recommended by the Sarbanes–Oxley Act.

"An external auditor should not have other consulting or conflict-of-interest relationships with top managers or board members."

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Define the Scope of the Audit Process

The ethics audit committee should establish the scope of the audit and monitor its progress to ensure that it stays on track. The scope of an audit depends on the type of business, the risks it faces, and the opportunities it has available to manage ethics. This step includes defining the key subject matter or risk areas that are important to the ethics audit (for example, sustainability, discrimination, product liability, employee rights, privacy, fraud, financial reporting, and/or legal compliance) as well as the bases on which these areas should be assessed. Assessments can be made on the basis of direct consultation, observation, surveys, or focus groups.[34] Table 9.5 lists some sample subject matter areas and the audit items for each.

Review Organizational Mission, Values, Goals, and Policies and Define Ethical Priorities

Because ethics audits generally involve comparing an organization's ethical performance to its goals, values, and policies, the audit process should include a review of the current mission statement and strategic objectives. A company's overall mission may incorporate ethics objectives, but these may also be found in separate documents, including those that focus on social responsibility. For example, a firm's ethics statement or statement of values may offer guidance for managing transactions and human relationships that support the firm's reputation, thereby fostering the confidence of the firm's external stakeholders.[35] Franklin Energy, for example, specifies the five core values it uses in managing its business, and which contribute to its success: ingenuity, results orientation, frugality, integrity, and environmental stewardship.[36]

This review step should include an examination of all formal documents that make explicit commitments to ethical, legal, or social responsibility, as well as less formal documents including marketing materials, workplace policies, ethics policies, and standards for suppliers or vendors. This review may reveal a need to create additional statements to fill the identified gaps or to create a new comprehensive mission statement or ethical policy that addresses any deficiencies.[37]

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TABLE 9.5 The Ethics Audit

Organizational Issues*		
Yes	No	1. Does the company have a code of ethics that is reasonably capable of preventing misconduct?
Yes	No	2. Does the board of directors participate in the development and evaluation of the ethics program?
Yes	No	3. Is there a person with high managerial authority responsible for the ethics program?
Yes	No	4. Are there mechanisms in place to prevent the delegation of authority to individuals with a propensity for misconduct?
Yes	No	5. Does the organization effectively communicate standards and procedures to its employees via ethics training programs?
Yes	No	6. Does the organization communicate its ethical standards to suppliers, customers, and significant others that have a relationship with the organization?
Yes	No	7. Do the company's manuals and written documents guiding operations contain messages about appropriate behavior?
Yes	No	8. Is there formal or informal communication within the organization about procedures and activities that are considered acceptable ethical behavior?
Yes	No	9. Does top management have a mechanism in place to detect ethical issues relating to employees, customers, the community, and society?
Yes	No	10. Is there a system in place for employees to report unethical behavior?
Yes	No	11. Is there consistent enforcement of standards and punishments in the organization?
Yes	No	12. Is there a committee, department, team, or group that deals with ethical issues in the organization?
Yes	No	13. Does the organization make a continuous effort to improve its ethical compliance program?
Yes	No	14. Does the firm perform an ethics audit?
Examples of Specific Issues That Could Be Monitored in an Ethics Audit†		
Yes	No	1. Are there any systems or operational procedures in place to safeguard individual employees' ethical behavior?
Yes	No	2. Is it necessary for employees to break the company's ethical rules to get the job done?
Yes	No	3. Is there an environment of deception, repression, and cover-ups concerning events that would embarrass the company?
Yes	No	4. Are there any participatory management practices that allow ethical issues to be discussed?
Yes	No	5. Are compensation systems totally dependent on performance?
Yes	No	6. Does sexual harassment occur?

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Yes	No	7.	Does any form of discrimination—race, sex, or age—occur in hiring, promotion, or compensation?
Yes	No	8.	Are the only standards about environmental impact those that are legally required?
Yes	No	9.	Do the firm's activities show any concern for the ethical value systems of the community?
Yes	No	10.	Are there deceptive and misleading messages in promotion?
Yes	No	11.	Are products described in misleading or negative ways or without communicating their limitations to customers?
Yes	No	12.	Are the documents and copyrighted materials of other companies used in unauthorized ways?
Yes	No	13.	Are expense accounts inflated?
Yes	No	14.	Are customers overcharged?
Yes	No	15.	Does unauthorized copying of computer software occur?

*A high number of "Yes" answers indicates that ethical control mechanisms and procedures are in place within the organization.
†The number of "Yes" answers indicates the number of possible ethical issues to address.

It is also important to examine all of the firm's policies and practices with respect to the specific areas covered by the audit. For example, in an audit that scrutinizes discrimination issues, this review step would consider the company's goals and objectives as well as its policies related to discrimination. It would consider the means available for communicating the firm's policies and assess their effectiveness. Such an evaluation should also look at whether and how managers are rewarded for meeting their goals and the systems employees have through which to give and receive feedback. An effective ethics audit will review all these systems and assess their strengths and weaknesses.[38]

Concurrent with this step in the auditing process, the firm should define its ethical priorities. Determining these priorities is a balancing act because identifying the needs and assessing the priorities of each stakeholder can be difficult. Because there may be no legal requirements for ethical priorities, it is up to management's strategic planning processes to determine risks, designate appropriate standards, and outline processes of communication with stakeholders. It is very important at this stage to articulate the firm's ethical priorities and values as a set of parameters or performance indicators that can be objectively and quantitatively assessed. Because the ethics audit is a structured report that offers quantitative and descriptive assessments, actions should be measurable by quantitative indicators. However, it is sometimes not possible to go beyond description.[39]

At some point, a firm must demonstrate action-oriented responsiveness to those ethics issues to which it has given top priority. For example, Niagara Mohawk Power Co. has a long history of working to minimize damage to the environment. The firm has adopted the international standard for environmental management systems, ISO 14001, and the guidelines specified by ISO 14001 require external auditing by a certified auditor. Additionally, Niagara Mohawk has a global Corporate Responsibility Summary Report on its corporate website.[40]

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Collect and Analyze Relevant Information

The next step in the ethical audit framework is to identify the tools or methods for measuring a firm's progress in improving employees' ethical decisions and conduct. In this step, the firm should collect relevant information for each designated subject matter area. To understand employee issues, for example, the auditing committee should work with the firm's human resources department to gather employee survey information and other statistics and feedback. A thorough ethics audit will review all relevant reports, including external documents sent to government agencies and others. Attempts to measure a firm's sustainability strategy will often depend upon a company's own reports and secondary data.[41] The information collected in this measurement step should help determine baseline levels of compliance as well as the internal and external expectations of the company. This step will also identify where the company has, or has not, met its commitments, including those dictated by its mission statement and other policy documents. The documents reviewed in this process will vary from company to company, depending on the firm's size and the nature of its business, as well as the scope of the audit process.[42] At Green Mountain Coffee, the audit committee of the board of directors is responsible for providing oversight of reporting procedures and audits. Green Mountain's code of ethics, described in Table 9.6, provides a framework for the principles that are the backbone of the ethics audit.[43]

Some techniques for collecting evidence might involve examining both internal and external documents, observing the data-collection process (for example by consulting with stakeholders), and confirming information in the organization's accounting records. Auditors may also employ ratio analysis of relevant indicators to identify any inconsistencies or unexpected patterns. Objective measurement is the key consideration of the ethics auditor.[44]

Stakeholder involvement is another important component in the successful implementation of an ethics audit, as stakeholders can yield significant insights. In one study

TABLE 9.6 Green Mountain Coffee's Code of Ethics

Green Mountain Coffee's Code of Ethics
• Respect the rights and the property of others
• Maintain accurate records and report unethical behavior
• Comply with all laws, rules, and regulatory requirements
• Avoid conflicts of interest and any appearance of impropriety
• Be responsible stewards in the use, protection, and management of GMCR's assets and resources
• Understand antitrust laws and uphold fair competitive practices
• Share GMCR's story while following the Media Relations guidelines on consistent communications
• Act with integrity while maintaining the confidentiality of GMCR information
• Support GMCR's Purpose, Principles, Policies, and Procedures and encourage GMCR's business partners to do so as well

Source: Adapted from GMC's Code of Ethics, http://files.shareholder.com/downloads/GMCR/1200861996x0x383775/36dbb352-934f-4e7b-9001-9d0c581a6410/GMCR_WebDoc_7206.pdf (accessed March 23, 2011).

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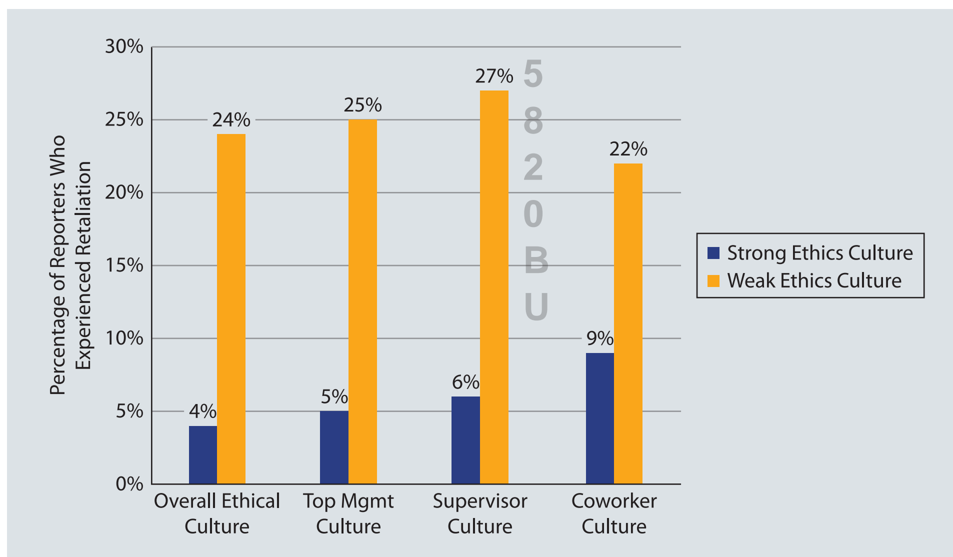
examining reporting channels, employees were asked to whom they would "feel comfortable" reporting misconduct if they suspected or became aware of it. Supervisors and local managers received the most favorable responses, suggesting the need for organizations to ensure that front-line managers are equipped to respond appropriately to allegations. It is worth noting that those functions primarily charged with taking action in response to alleged misconduct (legal, internal audit, and board or audit committee functions) were cited among the less likely channels that employees would feel comfortable using to report allegations. A company's ethical culture also determines whether those who report misconduct experience retaliation—and could also determine how often employees feel comfortable enough to report misconduct. Figure 9.4 shows that retaliation occurs more often in weaker ethical cultures. This makes it essential for management to create a strong ethical culture in which employees are encouraged to report observed misconduct.

Because integrating stakeholder feedback in the ethics audit process is so crucial, these stakeholders must first be defined and then interviewed during the data-collection stage. For most companies, stakeholders include employees, customers, investors, suppliers, community groups, regulators, nongovernment organizations, and the media. Both social and ethics audits typically interview and conduct focus groups with these stakeholders to gain an understanding of how they perceive the company. For example, the Chris Hani Baragwanath Hospital (CHBH) in Johannesburg, South Africa, conducted an ethics audit that included focus groups with the hospital's management, doctors, nurses, related health professionals, support staff, and patients. Using the trends uncovered in these focus groups, CHBH then developed an ethics survey questionnaire that it administered to a larger group of individual stakeholders.[45] The more stakeholders that auditors include in this measurement stage, the more time and resources the audit will consume. However, a larger sample of stakeholders may yield a more useful variety of opinions

FIGURE 9.4 Correlation between Retaliation and Corporate Culture



Source: Retaliation: The Cost to Your Company and Its Employees, (Arlington, VA: Ethics Resource Center, 2010), p. 10.

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about the company. Multinational corporations must also make decisions about whether to include in the audit only the main office or headquarters region or all of its facilities around the globe.[46]

Because employees carry out a business's operations, including its ethics initiatives, understanding employee issues is vital to a successful audit. Useful indicators for assessing employee issues include staff turnover and employee satisfaction. High turnover rates could indicate poor working conditions, an unethical culture, inadequate compensation, or general employee dissatisfaction. Companies can analyze these factors to determine key areas for improvement.[47] Questionnaires that survey employees' perceptions of the ethics of their company, their superiors, their coworkers, and themselves, as well as ratings of ethical or unethical practices within the firm and industry, can serve as benchmarks in an ongoing assessment of ethical performance. Then, if unethical behavior increases, management will better understand what types of unethical practices may be occurring and why. For example, the CHBH ethics survey asked employees about many issues, including corporate culture and values, their work space, human resources issues, misconduct, standards of patient care, and problems and sources of stress.[48] Most organizations recognize that employees will behave in ways that lead to recognition and rewards and avoid behavior that results in punishment. Therefore, companies can design and implement human resources policies and procedures for recruiting, hiring, promoting, compensating, and rewarding employees that encourage ethical behavior.[49]

Customers are another primary stakeholder group because their patronage and loyalty determines a company's financial success. Providing meaningful feedback is critical to creating and maintaining customer satisfaction. Through surveys and customer-initiated communication systems such as response cards, online social networks, e-mail, and toll-free numbers, organizations can monitor and respond to customer issues and its perceived social performance. Procter & Gamble uses online social networking sites such as Facebook to determine which social issues consumers are passionate about, as well as to gain insights into consumers' product needs and reactions to products.

A growing number of investors are seeking to include in their investment portfolios the stocks of companies that conduct ethics and social audits. They are becoming more aware of the financial benefits that can stem from socially responsible management systems—as well as the negative consequences of a lack of responsibility. President Obama praised City National Bancshares CEO Leonard Abess after he distributed his entire $60 million bonus to employees. On the other hand, Martin Sullivan, former CEO of AIG, approved $165 million and $121 million in bonuses to the Financial Products Group and executives and other employees, respectively. Sullivan was ousted before the company took $200 billion in government bailout money, which was funded by U.S. taxpayers.[50]

Even the hint of wrongdoing can affect a company's relations with investors. Moreover, many investors simply do not want to invest in companies that engage in certain business practices, such as the use of sweatshops or child labor, which fail to provide employees with adequate working conditions. It is therefore critical that companies understand the issues of this very important group of stakeholders and what they expect from corporations in which they have invested, both financially and socially.

> **"Even the hint of wrong doing can affect a company's relations with investors."**

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Organizations can obtain feedback from stakeholders through standardized surveys, interviews, and focus groups. Companies can also encourage stakeholder exchanges by inviting specific groups together for discussions. Such meetings also may include an office or facility tour or a field trip by company representatives to sites in the community. Regardless of how companies collect information about stakeholders' views, the primary objective is to generate a variety of opinions about how the company is perceived and whether it is fulfilling stakeholders' expectations.[51]

Once this information has been collected, the firm should compare its internal perceptions to those discovered during the stakeholder assessment stage and summarize its findings. During this phase, the audit committee should draw some conclusions about the information it obtained in the previous stages. These conclusions may involve descriptive assessments of the findings, such as the costs and benefits of the company's ethics program, the strengths and weaknesses of the firm's policies and practices, the nature of feedback from stakeholders, and issues that should be addressed in future audits. In some cases, it may be appropriate to see how the findings fit with standards identified earlier, both quantitatively and qualitatively.[52]

Data analysis should also include an examination of how other organizations in the industry are performing in the designated subject areas. For example, the audit committee can investigate the successes of some other benchmark firm that is considered the best in a particular area and compare the auditing company's performance to it. Some common examples of the benchmark information available from most corporate ethics audits are employee or customer satisfaction, how community groups perceive the company, and the impact of the company's philanthropy. For example, the Ethics and Compliance Officer Association (ECOA) conducts research on legal and ethical issues in the workplace. These studies allow ECOA members to compare their responses to the aggregate results obtained through the study.[53] Such comparisons can help the audit committee identify best practices for a particular industry or establish a baseline for minimum ethics requirements. It is important to note that a wide variety of standards are emerging that apply to ethics accountability. The aim of these standards is to create a tool for benchmarking and a framework for businesses to follow.

Verify the Results

The next step is to have an independent party—such as a social/ethics audit consultant, a financial accounting firm that offers social auditing services (such as KPMG), or a nonprofit special interest group with auditing experience (for example, the New Economics Foundation)—verify the results of the data analysis. Business for Social Responsibility, a nonprofit organization supporting social responsibility initiatives and reporting, has defined *verification* as an independent assessment of the quality, accuracy, and completeness of a company's social report. Independent verification offers a company, its stakeholders, and the general public a measure of assurance that the company has reported its ethical performance fairly and honestly, as well as providing an assessment of the company's social and environmental reporting systems.[54] It also lends an audit report credibility and objectivity.[55] Siemens AG in Munich, for example, had its sustainability report verified by the accounting firm PricewaterhouseCoopers.[56] However, a survey conducted by one of the Big Four accounting firms found that only a few social reports contained any form of external verification.

This lack of third-party assurance may have contributed to the criticism that social and ethics auditing and reporting have more to do with public relations than genuine

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change. But though the independent validation of ethics audits is not required, the number of independently verified reports is increasing.[57] Many public policy experts believe that an independent, objective audit can be provided only if the auditor has played no role in the reporting process—in other words, consulting and auditing should be distinctly separate roles. The Sarbanes–Oxley Act essentially legalized this belief.

Verification of the results of an audit should involve standard procedures that control the reliability and validity of the information. As with a financial audit, auditors can apply substantive tests to detect material misstatements in the audit data and analysis. The tests commonly used in financial audits—confirmation, observation, tracing, vouching, analytical procedures, inquiry, and recomputing—can be used in ethics and social audits as well. For example, positive confirmations can be requested from the participants of a stakeholder focus group to verify that the reported results are consistent with the results the focus group believed it found. Likewise, an ethics auditor can observe a company's procedures for handling ethical disputes to verify statements made in the report. And just as a financial auditor follows supporting documents to financial statements to test their completeness, an ethics auditor or verifier may examine employee complaints about an ethics issue to check whether the reporting of such complaints was complete. An auditor can also employ analytical procedures by examining plausible relationships such as the prior year's employee turnover ratio or the average turnover rate commonly reported within the industry. With the reporting firm's permission, an auditor can contact the company's legal counsel to inquire about pending litigation that may shed light on ethical and legal issues currently facing the firm.[58]

Additionally, a financial auditor may be asked to provide a letter to the company's board of directors and senior managers to highlight inconsistencies in the reporting process. The auditor may request that management reply to particular points in the letter to indicate the actions it intends to take to address problems or weaknesses. The financial auditor is required to report to the board of directors' financial audit committee (or equivalent) any significant adjustments or difficulties encountered during the audit as well as any disagreements with management. Therefore, ethics auditors should be required to report to the board of directors' audit committee the same issues that a financial auditor would report.[59] Green Mountain Coffee uses this method.

Report the Findings

The final step in our framework is issuing the ethics audit report. This involves reporting the audit findings through a formal report to the relevant internal parties, namely, the board of directors and top executives, and, if approved, to external stakeholders. Although some companies prefer not to release the results of their audits to the public, more companies are choosing to make their reports available to a broad group of stakeholders. Some companies, including the U.K.-based Co-operative Bank and the British newspaper *The Guardian,* integrate the results of their social audits with their annual financial reports and other important information. Many other companies, including Johnson and Johnson, Shell, and Green Mountain Coffee, also make their audit reports available on their corporate websites.[60]

Based on the guidelines established by the Global Reporting Initiative and Accountability, the report should spell out the purpose and scope of the audit, the methods used in the audit process (evidence gathering and evaluation), the role of the (preferably independent) auditor, any auditing guidelines followed by the auditor, and any reporting guidelines followed by the company.[61] The ethics audit of Johannesburg's Chris Hani Baragwanath Hospital followed these guidelines.[62] The report is more meaningful if it is

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integrated with other organizational information available, such as financial reports, employee surveys, regulatory filings, and customer feedback. The firm might also want to include in its ethics audit a section on best industry practices and how the firm compares to other companies in its field. Such a comparison can help a firm to identify its weaknesses and develop suggestions for improvement. The use of information such as the OCEG Benchmarking Study pinpoints key elements of corporate and ethics programs that could help assess best practices across the industry.[63]

As mentioned earlier, ethics audits may resemble financial audits, but they take quite different forms. In a financial audit, the Statement of Auditing Standards dictates literally every word found in a financial audit report in terms of content and placement. Based on the auditor's findings, the report issued can take one of the following four forms, among other variations. An *unqualified opinion* states that the financial statements are fairly stated. A *qualified opinion* asserts that although the auditor believes the financial statements are fairly stated, an unqualified opinion is not possible either because of limitations placed on the auditor or because of minor issues involving disclosure or accounting principles. An *adverse opinion* states that the financial statements are not fairly stated. Finally, a *disclaimer of opinion* states that the auditor did not have full access to records or discovered a conflict of interest. These different opinions each have enormous consequences for companies.

DEBATE ISSUE | TAKE A STAND

Which Ethics Audit Process Works Better for Smaller Companies?

ABC Specialty Marketing, Inc., is considering a formal ethics audit. The company has about 200 employees, including 50 salespeople that sell promotional printing products. Recent ethical issues have raised concerns within the company, causing the last board of directors to think about implementing a formal ethics audit. During the meeting, one of the board members who had examined the auditing process represented in Table 9.5 indicated that for a small company, this approach looked too formal. He felt that the Better Business Bureau Torch Award Criteria for ethical companies was a more practical approach to auditing ethical risks and conduct. Another member pointed out that the BBB criteria were more for judging than for understanding the risk areas and ethics program implementation concerns. This led to a discussion about how to implement an ethics audit in such a small company with a fairly limited ethics program. The meeting ended without a clear decision on which approach to use.

1. The Better Business Bureau Torch Award Criteria is the best method for conducting a formal ethics audit in a smaller company.
2. The auditing process represented in Table 9.5 offers a better way to understand a small company's ethical risks and conduct.

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THE STRATEGIC IMPORTANCE OF ETHICS AUDITING

Although the concept of auditing implies an official examination of ethical performance, many organizations audit their performance informally. Any attempt to verify outcomes and compare them with standards can be considered an auditing activity. Many smaller firms probably would not use the word *audit,* but they do perform auditing activities. Organizations such as the Better Business Bureau (BBB) provide awards and assessment tools to help any organization evaluate its ethical performance. Companies with fewer resources may wish to use the judging criteria from the BBB's Torch Award Criteria for Ethical Companies (Table 9.7) as

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TABLE 9.7 Better Business Bureau's Torch Award Criteria for Ethical Companies

A business should demonstrate its superior commitment to exceptional standards that benefit its customers, employees, suppliers, shareholders and surrounding communities. The business must provide supporting documentation in four areas for consideration in the Marketplace Excellence category. While examples from all four areas must be provided, the bullet points below are only suggestions and not all bullet points are required to be addressed in order for a business to compete in this category.

Management Practices

Note: Owners of companies with no employees must explain how a personal commitment to exceptional standards is applied in business practices.

- Pertinent sections from an employee handbook, business manual or training program (formal or informal) showing how the business's commitment to exceptional standards are communicated to and implemented by employees
- A vision, mission or core values statement describing the business's commitment to exceptional standards that benefit its customers, employees, suppliers, shareholders and surrounding communities
- Formal training and/or procedures used to address concerns an employee may have in dealing with ethical issues
- Management practices and policies that foster positive employee relations
- Employee benefits and/or workplace practices contributing to the quality of family life
- Actions taken to assess and mitigate risks, and prevent workplace injury
- Examples of sound environmental practices
- Examples of operational practices focused on security and privacy issues—on and offline
- Illustrations of your business's commitment to standards that build trust in the marketplace (i.e., customer service program, employee relation policy or practice, vendor/supplier relationship, etc.)

Community/Investor/Stakeholder Relations

- Examples of the business's vision, mission and/or core values statement in action—describing how the business's beliefs have been leveraged for the benefit of consumers, employees, suppliers, shareholders, and surrounding communities
- Business policies and practices that demonstrate accountability and responsibility to communities, investors and other stakeholder audiences
- Corporate governance practices address accountability and responsibility to shareholders
- Complimentary feedback from customers, vendors, suppliers and/or community leaders
- Actions taken by the business demonstrating service "beyond the call of duty"
- Brief case study examples of circumstances in which the business made tough decisions that had negative short-term consequences, but created long-term value and benefits
- Examples of, and results produced by, pro bono work
- Examples of the business working closely within the community and making a positive social impact—and any recognition for charitable and/or community service projects.

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Communications and Marketing Practices

- Descriptions of methods the business uses to ensure all sales, promotional materials and advertisements are truthful and accurate
- Sales training policies and/or codes of ethics used by sales personnel that ensure all transactions are made in a transparent, honest manner
- Crisis communications efforts and associated marketing actions that educated audiences, prevented negative outcomes and restored trust and confidence in the business, its products and services
- Examples of internal communications practices benefiting employees and contributing to overall business effectiveness and efficiency

Industry Reputation

- Media coverage reflecting the business's industry and community reputation as a trustworthy business
- Awards, recognition and/or complimentary letters from within the business's industry, trade group or community

Source: "International Torch Award Judging Criteria," Better Business Bureau, http://www.bbb.org/international-torch-awards/critera.html (accessed March 23, 2011).

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benchmarks for their informal self-audits. Recent winners of this award included Amazon.com, Verizon, and Villa Springfield Health & Rehabilitation Center.[64] The award criteria even provide a category for companies with less than 10 employees.

An ethics audit, like a financial audit, should be conducted regularly rather than in response to problems or questions about a firm's priorities and conduct. In other words, the ethics audit is not a control process to be used during a crisis, although it can pinpoint potential problem areas and generate solutions in a crisis situation. As mentioned earlier, an audit may be comprehensive and encompass all the ethics and social responsibility areas of a business, or it can be specific and focus on one or two areas. One specialized audit could be an environmental impact audit in which specific environmental issues, such as proper waste disposal, are analyzed. According to the KPMG International Survey of Corporate Responsibility Reporting, 80 percent of the 2,200 companies in 22 countries surveyed include CSR in their reporting, up from 50 percent in 2005.[65] Examples of other specialized audits include diversity, employee benefits, and conflicts of interest. Ethics audits can present several problems. They can be expensive and time consuming, and selecting the auditors may be difficult if objective, qualified personnel are not available. Employees sometimes fear comprehensive evaluations, especially by outsiders, and in such cases ethics audits can be extremely disruptive.

Despite these problems, however, auditing ethical performance can generate many benefits, as we have seen throughout this chapter. The ethics audit provides an assessment of a company's overall ethical performance as compared to its core values, ethics policy, internal operating practices, management systems, and most importantly, key stakeholder expectations.[66] As such, ethics and social audit reports are a useful management tool for helping companies identify and define their impacts and facilitate important improvements.[67] This assessment can be used to reallocate resources and activities as well as to

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focus on new opportunities. The audit process can also help companies fulfill their mission statements in ways that boost profits and reduce risks.[68] More specifically, a company may seek continual improvement in its employment practices, its customer and community relations, and the ethical soundness of its general business practices.[69] An audit can pinpoint areas where improving operating practices can improve bottom-line profits and stakeholder relationships.[70]

Most managers view profitability and ethics and social responsibility as a tradeoff. This "either/or" mindset prevents them from taking a more proactive "both/and" approach.[71] But the auditing process can demonstrate the positive impact of ethical conduct and social responsibility initiatives on the firm's bottom line, convincing managers—and other primary stakeholders—of the value of adopting more ethical and socially responsible business practices.[72]

SUMMARY

Viewing a business ethics program as a part of strategic planning and management activities is critical to the success of any firm. However, for such programs to be successful, firms must put controls and systems in place to ensure that they are being executed effectively. Controls include input, output, and process controls. Input controls are concerned with providing necessary tools and resources to the organization, such as good employees and effective ethics training and structural systems. Process controls include managerial commitment to an ethics program and to the methods or system for the evaluation of ethics. Output controls involve comparing standards with actual behavior. One of the most popular methods of evaluating ethical performance is an ethics audit.

An ethics audit is a systematic evaluation of an organization's ethics program and/or its ethical performance. Such audits provide an opportunity to measure conformity with the firm's desired ethical standards. The concept of ethics auditing has emerged from the movement toward auditing and reporting on companies' broader social responsibility initiatives. Social auditing is the process of assessing and reporting a business's performance in fulfilling the economic, legal, ethical, and philanthropic social responsibilities expected of it by its stakeholders. An ethics audit may be conducted as a component of a social audit. Auditing is a tool that companies can use to identify and measure their ethical commitment to stakeholders and to demonstrate their commitment to improving strategic planning, including their compliance with legal, ethical, and social responsibility standards.

The auditing process can highlight trends, improve organizational learning, and facilitate communication and working relationships. It can help companies assess the effectiveness of their programs and policies, identify potential risks and liabilities, improve compliance with the law, and demonstrate progress in areas of previous noncompliance. One of the greatest benefits of these audits for businesses is improved relationships with stakeholders. Ethics auditing may help prevent public relations crises associated with ethical or legal misconduct. Although ethics audits provide many benefits for companies and their stakeholders, they do have the potential to expose risks; the process of auditing cannot guarantee that a firm will not face challenges. Additionally, there are few common standards for judging disclosure and effectiveness or for making comparisons within an industry.

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An ethics audit should be unique to each company based on its size, industry, corporate culture and identified risks, and the regulatory environment in which it operates. This chapter has offered a framework for conducting an ethics audit that can also be used for a broader social audit.

The first step in conducting an audit is securing the commitment of the firm's top management and/or its board of directors. The push for an ethics audit may come directly from the board of directors in response to specific stakeholder concerns or corporate governance reforms, or from top managers looking for ways to track and improve ethical performance. Whatever the source of the audit, its success hinges on the full support of top management.

The second step is establishing a committee or team to oversee the audit process. Ideally the board of directors' financial audit committee would oversee the ethics audit, but in most firms, managers or ethics officers conduct auditing. This committee recruits an individual from within the firm or hires an outside consultant to coordinate the audit and report the results.

The third step is establishing the scope of the audit, which depends on the type of business, the risks faced by the firm, and available opportunities to manage ethics. This step includes defining the key subject matter or risk areas that are important to the ethics audit.

The fourth step is a review of the firm's mission, values, goals, and policies. This step should include an examination of formal documents that make explicit commitments with regard to ethical, legal, or social responsibility, and less formal documents including marketing materials, workplace policies, and ethics policies and standards for suppliers or vendors. During this step, the firm should define its ethical priorities and articulate them as a set of parameters or performance indicators that can be objectively and quantitatively assessed.

The fifth step is identifying the tools or methods that can be used to measure the firm's progress, and then collecting and analyzing the relevant information. Some evidence-collection techniques include examining internal and external documents, observing the data-collection process (such as discussions with stakeholders), and confirming the information in the organization's accounting records. During this step, a company's stakeholders need to be defined and then interviewed to understand how they perceive the company, for example through standardized surveys, interviews, and focus groups. Once this information has been collected, it should be analyzed and summarized. Analysis should include an examination of how other organizations in the industry are performing in the designated subject matter areas.

The sixth step is having an independent party—such as a social/ethics audit consultant, a financial accounting firm that offers social auditing services, or a nonprofit special interest group with auditing experience—verify the results of the data analysis. Verification is an independent assessment of the quality, accuracy, and completeness of a company's audit process. Such verification gives stakeholders confidence in a company's ethics audit and lends the audit report credibility and objectivity. The verification of the results of an audit should involve standard procedures that control the reliability and validity of the information.

The final step in the audit process is reporting the audit findings to the board of directors and top executives and, if approved, to external stakeholders. The report should spell out the purpose and scope of the audit, the methods used in the audit process (evidence gathering and evaluation), the role of the (preferably independent)

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auditor, any auditing guidelines followed by the auditor, and any reporting guidelines followed by the company.

Although the concept of auditing implies an official examination of ethical performance, many organizations audit informally. Ethics audits should be conducted regularly. Although social auditing may present problems, it can also generate many benefits. Through the auditing process, a firm can demonstrate the positive impact of ethical conduct and social responsibility initiatives on its bottom line, which may convince stakeholders of the value of adopting more ethical and socially responsible business practices.

IMPORTANT TERMS FOR REVIEW

ethics audit **social audit**

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RESOLVING ETHICAL BUSINESS CHALLENGES*

As Jerry looked around at the other members of the board, he wondered if it was too late to resign. How could he have been stupid enough to get dragged into this ethics audit quagmire? It had started innocently enough. With the passing of the Sarbanes–Oxley Act, everyone was aware of the consequences of accounting problems and their potential negative impact on a company, its board members, and its employees. So when Jerry's friend John Jacobs, the president of Soumey Corp., asked him to be on the company's board of directors, Jerry had checked out the company. It wasn't that he didn't trust John; he just felt that he should never take unnecessary chances. But when Jerry's investigation of Soumey uncovered nothing unusual, he accepted the board position.

Besides Jerry and John, Soumey's board of directors included Alan Kerns, a retired Soumey executive; Alice Finkelstein, a retired executive from a similar company; and Latisha Timme, a consultant within the industry. After Jerry joined the board, one of its first tasks was to conduct an ethics audit. The directors decided to contract the task to Teico, Inron, and Wurrel (TIW), an accounting firm highly recommended by Latisha. A few months later, TIW filed its final report of the audit with the board. The report indicated that, with a few exceptions, Soumey was doing a good job of monitoring ethical issues. Among the recommendations that the report offered were that the company should appoint a person with high managerial authority to be responsible for its ethical compliance program, that it establish a confidential hotline for employees who had ethical or legal concerns, and that it create an ethics committee to address ethical issues in the organization.

At the next board meeting, John suggested that Alan be the ethics compliance officer because he lived close to the main offices and had time to do it. Alan quickly agreed, provided there was substantial remuneration for his time, which John affirmed. Jerry asked a few questions, such as whether Alan had sufficient managerial authority.

Alice responded, "Jerry, this industry is rather small. There are only a few large players, Soumey being one of them. Trust me when I say that Alan, as a retired president of the company, will definitely have the respect of the employees."

Jerry had no more questions, and Alan became Soumey's new compliance officer. The confidential hotline was quickly installed, and announcements about its existence were widely distributed around the various offices and plant buildings to ensure that it reached each of the firm's several thousand employees. The board also discussed TIW's final suggestion for an ethics committee, and all but Jerry agreed that the board could handle that task as well.

Jerry pointed out, "I don't think this is wise, John. This is a conflict of interest for you, isn't it?"

After a moment of hesitation, John replied, "You're right, Jerry, it is a conflict of interest for me to serve on the ethics committee." After another bit of silence, John suggested, "Wouldn't you agree that I should not be on the committee, Alan, Alice, and Latisha?" They all discussed the matter and agreed that Jerry's suggestion made perfect sense.

Time passed, and the board held its quarterly meetings. Nothing unusual was brought up, just the same old issues that any publicly held company must deal with relative to shareholders, lawyers, regulators, and the public. Alan had suggested that the ethics compliance committee meet twice a year so that he could fill everyone in on what was happening. At these meetings, Alan would usually report the number of calls to the hotline, the status of complaints, and whether there were any serious allegations such as sexual harassment or any reported forms of race, sex, or age discrimination in hiring personnel.

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After two years of quarterly board meetings and semiannual ethics meetings, Jerry suggested to Alan that they conduct another ethics audit.

"Why would we want to do that, Jerry? Things are going smoothly with the approach we're taking. Why have another outside audit? Do you think that we're doing a bad job?"

Jerry hedged. "I'm not saying that, Alan. What I'm saying is that we may need to have an outside audit just to make sure everything looks good to the public. Why don't we discuss this with Latisha and Alice this week?"

Alan agreed, but when the ethics committee met that week it was obvious to Jerry that Alan had spoken to Alice and Latisha about his and Jerry's meeting. He wasn't surprised when the committee decided that another audit would diminish confidence in Alan's performance as ethics compliance officer. Several weeks later, John sent all the board members a letter announcing an increase in their pay as board directors as well as doubling their pay as ethics committee members. The letter stated, "Soumey Corp. has decided that your service to the company has been exemplary, both as board members and as an ethics committee."

In Jerry's third year on the board of directors, he was finally able to attend Soumey's annual company picnic with his wife and children. They arrived late, after all of the introductions, and everyone was already in the buffet line. As a result, no one really knew who he was. The children were having fun, and Jerry and his wife, Rosa, were too. However, after a while Jerry began to overhear some interesting comments. In one conversation, a production worker spoke about a toxic spill that had occurred because of the lack of safeguards. He told his companion, "Yeah, I know it was pretty messy, but only a few of my crew were hurt."

His friend asked, "Did they or you report it to management?"

He exclaimed, "Are you kidding? My guys don't want to lose their bonuses. Remember what happened to Bob's crew when the same thing happened and some of his guys complained? They had them filling out paperwork for a whole day, and the next week they were assigned a project with no incentives. They lost 40 percent of what they'd been making with all the overtime and performance-based stuff. The guys and I agreed not to report it for those reasons."

Jerry couldn't help interrupting, "So why didn't the company fix the problem after it happened the first time?"

One of the men asked, "Are you new here?"

"Yeah, been here only a few weeks," Jerry lied.

The production worker answered, "You want to boost your pay, right? So you cut a few corners to get by."

Later that evening, after Jerry and his family had returned home, Rosa told him about a conversation she had overheard. "These women were talking about how unfair it is that most of the incentive-based pay seems to go to men with families. One woman said that she heard of a man over 55 who should have gotten a promotion, but who was turned down because his supervisor was told not to give it to him. Rumor was that this guy had bucked the last president of Soumey, and that was his payback. Jerry, you should have heard what they say about Alan—that he's like Santa Claus and the Grinch. You never see him—and if you do, it's not a pleasant experience. One woman told me that when she was working for him, he used to be a little too friendly. She said that's why no one really uses the ethics hotline for certain issues. They know that the fox is guarding the hen house."

A little later, one of Jerry's sons bounced into the room and asked him a question about the picnic. "Dad, how come all the Spanish-speaking workers are on the night shift? It really makes it hard for a couple of my friends to get their parents to drop them off for soccer."

The picnic opened Jerry's eyes to an uglier side of Soumey. At the next board meeting, he indirectly addressed some of the problems he had noticed. But John responded, "We're going into a recession, and we have to cut a few corners to keep our dividends up to the market's expectations. Latisha has been watching and consulting me on the best way to keep ahead of the pack on this."

Latisha and Alice both commented, "Thank goodness we have a large Hispanic workforce to

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offset some price increases. They're hard workers and don't complain."

"You're absolutely right," said Alan. "We don't have the EPA, OSHA, or other agencies on our backs because these people know how to work and keep quiet. If some federal agencies do start to poke around, I have some contingency plans to prevent any type of ethical disaster."

That evening Jerry and Rosa were talking about the situation. He told Rosa, "I think Soumey has some potentially ethical issues that need to be addressed—but what can I do?"

"Well," sighed Rosa, "We've lived in this town for a long time. We know the families that are on the board. They're good people. However, there's one thing you didn't hear at that picnic because of your lack of Spanish. I've told you that it's important to learn it, even if it's just for my family. A few of the people I overheard were talking about how the hotline isn't really anonymous. That's just not right, Jerry. You need to do something even if it does mean losing the extra income." Rosa's points struck a nerve because Jerry knew they were a little overextended financially.

"I'll see what I can do," he told her.

Still, she warned him, "That's good, honey, but remember I don't want you to make too many waves. We still have to live here, and you know we can't swing a dead cat and not hit one of the people at Soumey."

QUESTIONS | EXERCISES

1. What areas of its ethics audit should Soumey change?
2. Does Jerry have a duty to report any of the items that he has heard to an outside authority?
3. Is Jerry responsible for the problems associated with Soumey over the last three years? Explain why or why not.

*This case is strictly hypothetical; any resemblance to real persons, companies, or situations is coincidental.

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CHECK YOUR EQ

Check your EQ, or Ethics Quotient, by completing the following. Assess your performance to evaluate your overall understanding of the chapter material.

1.	Ethics audits are required by the Sarbanes–Oxley Act of 2002.	**Yes**	**No**
2.	In public corporations, the results of ethics audits should be reported to the board of directors.	**Yes**	**No**
3.	An ethics audit helps identify risks and rogue employees.	**Yes**	**No**
4.	The scope of an ethics audit depends on the type of risks and the opportunities to manage them.	**Yes**	**No**
5.	Smaller companies can skip the step of verifying the results of an ethics audit.	**Yes**	**No**

ANSWERS **1. No.** Financial audits are required, and these may address some ethical issues. **2. Yes.** This is consistent with good corporate governance but not required. **3. Yes.** This is the main benefit of an ethics audit. **4. Yes.** The scope determines the risks unique to the organization. **5. No.** Verification is necessary to maintain integrity and accuracy.

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