Business Ethics and Compliance:

Government and Contractor Cooperation in Fraud Prevention and Detection

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INTRODUCTION

You can't pick up a newspaper or turn on the television news today without hearing yet another disturbing story about corporate fraud in all its forms: bribery, gratuities, kickbacks, false claims, violations of the Foreign Corrupt Practices Act, or international trade and export control violations. Most of these stories begin with a rogue company employee, manager, or executive violating the rules; a Federal or State investigation leading to government prosecutions of both the employee and the company; lengthy and costly litigation; Justice Department settlements, convictions, and/or recoveries in the hundreds of millions; and corporate consent decrees with years of monitoring and reporting requirements. The end result is usually disastrous for companies and the people that run them: financial losses that can cripple a company's future; tanking of corporate and product reputation; further slide of stock prices; and the ousting of key corporate executives. In all of these scenarios, the Government's role is that of enforcer, prosecutor, and fine collector…all purportedly in the name of protecting the taxpayer.

But what if corporate wrongdoing could be avoided in the first place? What if the Government's substantial investment in meeting its prosecutorial metrics could be, in part, redirected toward corporate fraud prevention and risk management activities? What if the Government and industry could collaborate in creating an ethical corporate environment where the actions of rogue actors in a corporate setting could be discovered early, properly investigated, and cooperatively handled as an aberration rather than a corporate liability and indictment of an entire company's ethical culture?

Although Government investigators might point to increases in procurement fraud prosecutions to prove otherwise, this is precisely the direction we have started to head in recent years with increased corporate and government attention and resources dedicated to Corporate Business Ethics and Compliance programs. This presentation will discuss how we got here: the evolution of business ethics in the United States; the precarious state of ethics among our students, who represent our future employee base; why ethics is important amidst the current economic crisis; new government rules and regulations that promote fraud prevention and Government/corporate collaboration; a 2005 study by the American Management Association (AMA) and Human Resource Institute (HRI) that provided critical insights into what drives ethical corporate behavior; some best practices and a discussion of what it takes to implement an effective corporate business ethics program; and future trends in corporate ethics and responsibility.

THE EVOLUTION OF BUSINESS ETHICS

When speaking of ethics in a corporate or organizational context, one runs the risk of running afoul of the "prime directive" of 21st century management principles: matters of religion, morality, or the political expression of either of those issues must be left outside of the corporate doors. When we speak of *Business Ethics,* the most useful definition I have found is a simple one: "*Applying society's ethical norms to business dealings"*. This definition recognizes the reality that (1) ethical norms might (and often do) vary in different societies and countries; (2) what is considered ethical is constantly changing to reflect the current mood and tolerance level of the society at large (and is usually reflected in that society's laws); and (3) irrespective of an individual's personal values, religious views, or moral compass, once an employee walks through those corporate doors, the company can (and should) demand certain *behaviors* in running its business that are consistent with its corporate values.

The first written record I could find discussing ethics in a business context was from the writings of Aristotle more than 2,400 years ago. Aristotle wrote about both personal and organizational fairness, and the application of moral principles to the activities of commerce. He equated unscrupulous business dealings that harmed customers to the immorality of theft. In his *Nicomachean Ethics,* Aristotle concludes that the role of a ethical leader is not to enhance his or her own power but to create the conditions in which all members of an organization have the opportunity to realize their full potential. [1] He also raises some useful questions about the distribution of rewards in organizations based on the ethical principle of rewarding people proportionate to their contributions (this is very applicable to our discourse today concerning the appropriateness of executive compensation).

In 1468, a Dominican Friar names Johannes Nider wrote a document entitled *Contractibus Mercatorum,* which was an attempt to reconcile the teachings of the Catholic Church with the realities of emerging commerce and economic activity. [2] Nider strongly promoted the concept of "*Caveat Venditor*", which was a warning to the business person to take responsibility for the product he was producing and selling. This is the antithesis of the "*Caveat Emptor*", or "let the buyer beware" concept that became the underpinning of modern day capitalism.

As commerce and trade became more a part of everyday life, a series of European philosophers in the 17th and 18th centuries began to write with increasing urgency about the need to apply ethical behavior to business activity. The 18th century German philosopher Immanuel Kant argued that moral requirements are based on a standard of rationality he dubbed the "Categorical Imperative" (CI). [3] Immorality, perpetrated by either an individual or a commercial entity, thus involves a violation of the CI and is thereby irrational. The Scottish philosopher and economist Adam Smith, is best known as the author of *The Wealth of Nations,*

[1] O'Toole, James. 2009. "Advice from Aristotle". Santa Clara University Home Page (www.scu.edu/ethics).
[2] The Original Catholic Encyclopedia (on-line version), www.oce.catholic.com
[3] Stanford Encyclopedia of Philosophy (on-line version). www.stanford.edu.

the work that deeply influenced the politicians of the time and provided the intellectual foundation of the great 19th century era of free trade and economic expansion, guided by the "invisible hand" of the free market. However, Smith's earlier work, *The Theory of Moral Sentiments,* described how human beings have a natural sympathy for others, and how this interest in the fortune of others would serve to regulate and moderate free-market behavior and preserve harmony. [4]Smith saw the self-interest that drives the economy as a force for achieving the common good (the precursor of the "corporate responsibility" movement).

Perhaps the most famous and enduring critic of business and capitalism is the German philosopher and political economist Karl Marx, who wrote his influential and radical works in the 1800s. Marx's condemnation of capitalism, and belief in its ultimate self-destruction, have actually inspired generations of philosophers, politicians, and capitalists to demonstrate how ethical labor and business practices are possible under a capitalist system.

In the earliest years of the United States, corporations existed solely under state charters that held them and their officers to strict rules that included full liability, full disclosure of documents, and the performance of a "public purpose" (such as building warships or railroads). Corporations were also given a limited life span to meet that public purpose. [5] Unlike the recent Supreme Court decision, corporations were not permitted to make any political contributions, and were not afforded any rights other than those specifically granted by their state charter.

As the country's conflicts with France and England developed in the 1800s, President Thomas Jefferson imposed embargoes on all goods exported from those countries. Suddenly, American companies served a broader purpose, as they were needed to domestically produce those products that could no longer be obtained from Europe. These companies were no longer simply viewed as vehicles for providing a specific public purpose, but were entities that went into business to make money for the individuals that formed them. [6]

After America's Civil War, our expansion westward and the Industrial Revolution simultaneously drove the development of U.S. business. It was during this period that the "Robber Baron" business owners created huge commercial enterprises not previously seen in our country. Some of these businesses monopolized the markets, and as a result gained financial wealth and a great deal of political clout. Consequently, the U.S. Congress began passing some of the first laws designed to "rein in" the behavior of corporations and legislate corporate ethical behavior. These laws included the National Banking Act, the Tariff Act, and the Homestead Pacific Act. In an effort to evade these laws, some companies formed cartels to fix prices and squeeze out the competition. Public outcry against high prices caused by this monopolistic behavior resulted in the Sherman Antitrust Act of 1890. [7]

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[4] "Why Adam Smith is Important". www.adamsmith.org.
[5] American Management Association/Human Resource Institute. 2006. "The Ethical Enterprise: Doing the Right Things in the Right Ways, Today and Tomorrow. P. xi
[6] Ibid. p. xi
[7] Ibid. p. xi

Nearly twenty years later, President Woodrow Wilson suggested in a 1910 speech before the American Bar Association that the government had a critical role to play in regulating the behavior of U.S. business. The thinking at the time was that only true business competition and market pressures could force companies to behave ethically, so there was a renewed emphasis on "trust busting". This effectiveness of this strategy became questionable, since by 1932, one half of all corporate wealth in the U.S. was held by just 200 companies.[8]

The 20th century saw the creation of the first corporate codes of conduct for business. Edward Filene, the department store founder who was also the pioneer of social responsibility, articulated his own personal code of conduct in 1920 based on two principles: (1) "A business, in order to have the right to succeed, must be of real service to the community", and (2) "Real service in business consists of making or selling merchandise of reliable quality for the lowest possible, practicable price, provided that merchandise is made and sold under just conditions."[9]

From the 1930s through the 1960s, the focus of business ethics in the U.S. was limited to the issues of monopolies and labor conditions. A series of laws were passed during this period regarding fair labor practices (the Fair Labor Standards Act of 1938 and subsequent amendments), equal pay (the Equal Pay Act), civil rights (the Civil Rights Act of 1964), and discrimination (the Age discrimination in Employment Act of 1968). [10]

In the 1960s, "Mom and Pop" businesses that epitomized American free enterprise were beginning to be replaced by large corporations. The public began to examine the behavior of these larger companies and questioned their impact on the environment, their employees, small communities, and the society as a whole. Under attack, corporations began to develop the notion of "corporate social responsibility" to prove that they were responsible members of America's communities. Some business schools began to teach business ethics as a legitimate part of their course curriculum in the 1970s.

As the worldwide economy grew in the late 1970s and an increasing number of corporations began looking to overseas markets as a source of revenue and profit, foreign bribery scandals began to plague many U.S. companies. Such scandals offended the sensibilities of the American public, and pressured companies to establish corporate codes of conduct that specifically addressed their business practices. Nevertheless, the 1980s brought a stream of highly publicized problems in government contracting, particularly in the defense sector. The famous "$600 toilet seat" and other revelations of wasteful and abusive contracting practices prompted the growing U.S. defense industry to take matters into its own hands. In 1986, several defense contractors banded together and created the "Defense Industry Initiative" (DII). DII signatories committed to adopting and implementing an ethical culture, and the highest standards of ethics and business conduct. The companies also agreed to share information on best practices in their respective ethics programs. Perhaps the most significant and immediate impact of the DII was the creation of the DoD Voluntary Disclosure

[8] Ibid. p. xii
[9] Ibid, p. xii
[10] Ibid. p. xii

Program, where the companies committed to self-reporting fraud and other illegal activities on government contracts to the DoD.

In spite of these efforts, corporate ethical lapses have continued over the past three decades. The 1980s were marked by scandals involving junk bonds and corporate raiders; and corporate and stock market policies in the 1990s set the stage for some of the most egregious corporate scandals in our nation's history at the turn of the century. Enron, WorldCom, Tyco, and Adelphia, to name a few, became household names synonymous with corporate fraud and unethical behavior. The behavior of these companies led many to believe that greater government oversight was needed, prompting passage of the Sarbanes-Oxley Act in 2002, and a near doubling in funding for the Securities and Exchange Commission (to nearly $300 million) between 2000 and 2004.

Although much maligned because of its complexity and cost for companies to implement, the Sarbanes-Oxley Act of 2002 (SOX) was a landmark piece of legislation designed to protect investors by creating much higher corporate financial and reporting standards that must be verified by outside auditors and overseen by an independent oversight board. SOX also furthered the cause of corporate ethics and compliance activities by requiring employee training in ethical business practices; confidential processes for employees to report wrongdoing; and whistleblower protections.

On the heels of SOX, the U.S. Sentencing Commission strengthened its Federal Sentencing Guidelines in November 2004 by focusing, for the first time, on the strength of a company's internal ethics and compliance program as evidence of "due diligence" should a company be prosecuted for fraud or other illegal activities. Specifically, the guidelines require that companies' governing authorities be "knowledgeable about the content and operation of [their company's] compliance and ethics program" and "exercise reasonable oversight with respect to the implementation and effectiveness of the program."[11] The Commission identified several other "minimum steps" that, if properly implemented by companies, could help mitigate the consequences should there be an ethical lapse and criminal conduct has occurred. These steps include the development of clearly enunciated standards of conduct; effective communication and training on the standards; discipline for infraction of the standards; careful delegation of authority; monitoring and auditing of program efforts; and consistent process modifications upon findings of deficiencies.[12]

STATE OF ETHICS TODAY

When hiring entry-level employees, many companies make an assumption, based on the quality of the college or university attended and academic success achieved, that the new employee arrives with a basic set of values and sense of integrity that is generally consistent with those of their organization. Thirty minutes or an hour of ethics training a year, maybe

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[11] U.S. Sentencing Commission, Federal Sentencing Guidelines, November 2004.

[12] Desio, Paula J. Ethics Resource Center Policy Report, "Ethics and Compliance Programs May Get Their Day in Court", 2009. p.7

some specialized computer-based training on following relevant laws and regulations, and the new employee is deemed “good to go” from a corporate ethics perspective.

If only this were true. The latest available data on student cheating while in high school, college, and graduate school, and related perceptions about what it takes to succeed in business today, details a disturbing and fundamental shift in the values of the nation’s emerging workforce. Josephson Institute's 2008 Report Card on the Ethics of American Youth is based on a survey of 29,760 students in public and private high schools across the United States. The study revealed that in the previous year, ***78 percent of high school students surveyed reported cheating.*** In addition, ***64 percent of students admitted to cheating on a test in the previous year,*** and ***38 percent did so two or more times.*** This data represents a significant shift in the values of societal youth: 60 years ago, only 20 percent of college students admitted to having cheated while in high school; today***, only 22 percent report that they did not cheat.***[13]

Perhaps even more startling is the ethics posture of college students working toward graduate school admission. According to a Rutgers University nationwide survey of college students, an alarming number of college students freely admit that they cheated to get into Graduate school. The percentages vary depending on field of study, from a low of 43 percent (Liberal Arts), 52 percent (Education), and 63 percent (Law and Medicine). The highest percentage of college cheaters was in the field of Business, where **75 percent of students admitted that they cheated to get into MBA programs**. [14]While in graduate school, the ethics challenges continue. According to the Rutgers study, **56 percent of MBA students admitted to cheating while in graduate schools**; the percentages are similarly discouraging for Engineering (54 percent), Education (48 percent), and Law (45 percent).

The student respondents in the Rutgers Study rationalized their cheating in a manner similar to white collar criminals who are caught committing fraud. Many cite pressure from parents and professors; the intense competition at the school; a perception that “everyone is doing it”; and most importantly, a belief that cheating is the “way of the world” - - a skill that will be necessary to use when they get into the business world. It appears that these students, who represent our future workforce, are getting the message that the ends justify the means; that cheating is necessary to succeed in the business world; and that cheating is rewarded. Where could they have gotten this idea? We have only to examine the behaviors of numerous companies in the financial industry over the last year that, in spite of nearly bringing down the entire U.S. financial system, continued to reward their executives with lavish compensation packages.

The state of ethical behavior and misconduct within U.S. business, while showing some recent improvement, remains a cause for concern. According to the 2009 National Business Ethics Survey conducted by the Ethics Resource Center (ERC), almost half of all employees said they witnessed misconduct on the job, but 37 percent of those who witnessed misconduct

[13] Josephson Institute of Ethics, 2008 Report Card on the Ethics of American Youth. www.charactercounts.org
[14] Rutgers University National Survey of Students, 2004.

declined to report it. Almost 40 percent of employees surveyed said that they feared retaliation if they came forward with allegations of misconduct. On the positive side, the ERC's measure of the strength of ethical culture within companies improved from 53 percent in 2007 to 62 percent in 2009. The ERC concludes that ethical culture is the single biggest factor determining the amount of misconduct that will take place in business, and that executives who fail to elevate ethics culture to a priority will risk long-term business problems.[15]

WHY WORRY ABOUT ETHICS NOW?

Given the continuing dismal state of the economy, high unemployment, and many businesses just struggling to survive, do we really have the time to worry about corporate business ethics programs right now? The reality is that in the current economic environment, corporate business ethics and compliance programs are more important than ever. This is particularly true in those businesses that have contracts with federal, state, or local government. Here's why:

Mistrust of "Corporate America" is at an all-time high. According to the 2009 Edelman Trust Barometer public trust in U.S. business stands at 38 percent, down from 58 percent a year earlier. The only institution in the U.S. with a lower public trust rating is the United States Congress.

Federal Contracting Has Been Plagued with Fraud and Abuse. We've all heard the stories of companies that have bilked the government through war profiteering; the Committee on Oversight and Government Reform identified 187 contracts valued at $1.1 trillion that have been plagued by waste, fraud, and abuse over the last six years. Reports like these cast a shadow over ALL government contracting, in spite of the fact that most of these fraud cases occurred in the war zones; most government contracting is NOT involved; and few companies (rather than bad actors ***within*** companies) have intentionally defrauded the government. Contractors are viewed as "the enemy", in spite of the fact that the mission of most governments cannot be accomplished without the goods and services they provide. Corporate ethics and compliance programs are critical to rebuilding public confidence.

Fraud Increases During Economic Turmoil. According to the ERC, misconduct in the workplace rises as much as 11 percent when financial or economic turmoil rocks an organization. Employees, supervisors, and managers all feel extra pressure to meet goals, and internal controls are often reduced. A Deloitte Financial Advisory Services survey found that 63 percent of executives expect accounting fraud to increase during the next two years because of the U.S. recession.

NEW GOVERNMENT REQUIREMENTS ON BUSINESS ETHICS

Last year, the Federal Government amended its Federal Acquisition Regulations (FAR) to require, by law, all federal contractors (with contracts in excess of $5 million) to disclose to Inspectors General "credible evidence of a violation of Federal criminal law" involving, fraud,

[15] 2009 National Business Ethics Survey, Ethics Resource Center. www.ethics.org

conflicts of interest, bribery, or gratuity violations, or a violation of the civil False Claims Act, where such evidence arises in connection with a federal contract. The penalty for non-compliance for "failing to timely disclose" can include federal agency suspension or debarment of the company.

This mandatory fraud reporting provision, long resisted by industry, was enacted in the wake of data indicating that disclosures under the DoD Voluntary Disclosure Program had significantly declined from a high of near 60 almost 20 years ago to a low of about 6 in 2008. The decline in voluntary disclosures came at a time when the number of fraud allegations being investigated by government agencies and prosecuted by the Department of Justice had risen dramatically.

While the mandatory reporting provisions contained in the FAR were important, the final FAR rule contains several proactive measures (often overlooked by federal agencies) designed to enhance contractor business ethics and compliance programs and have an even more profound, lasting impact on fraud prevention and detection efforts. These provisions amplify the requirement for a contractor code of business ethics and conduct; require effective training programs for contractor principals and employees, as well as a flow-down requirement for subcontractors; direct that contractors have an internal control system in place to ensure the effectiveness of their ethics programs; and require periodic reviews of company business practices and internal controls. Federal agencies are now required to add a business integrity component to their required evaluation of a prospective contractor's past performance, and use that information as part of all future source selections.

One federal agency has used this business integrity mandate as an opportunity to collaborate with its industrial partners. At the National Reconnaissance Office (NRO), an Intelligence Community agency responsible for the research and development, acquisition, launch, and operations of the nation's spy satellites, a senior official is tasked with assessing the ethics and integrity posture of major contractors and subcontractors. This is accomplished by reviewing contractors' business ethics and compliance activities (at both the corporate and business unit levels) against the latest industry standards. Suggestions are made to the contractors for improving their programs (if necessary), best practices and new ideas are cross-fertilized between companies, and feedback is provided to the Director of the NRO and agency contracting officials. This feedback is centered on business ethics and compliance programs as risk reduction tools; companies are assigned a rating of low risk, elevated risk, or high risk in executing high dollar-value contracts.

Based on the history described earlier in this paper, it would be reasonable to ask, "Don't most major U.S. corporations already have Business Ethics and Compliance Programs"? The answer is a simple "yes", they do. But not all business ethics programs are rated equal. While most major U.S. companies have an ethics officer, Ethisphere Institute reports that many companies have paid "lip service" to corporate ethics and compliance, maintaining such departments but sidelining them during deliberations on major decisions. For example, by several accounts AIG, the financial industry insurance giant that played a major role in the U.S.

financial meltdown and bailout program, kicked the company's compliance officer out of key meetings where its approach to the mortgage derivatives business was discussed.

Certainly, some of the companies most notorious for their ethics scandals had previously been recognized for their "world class" business ethics and compliance programs. The "big daddy" of them all is Enron, whose CEO, Ken Lay penned a letter to many of its clients touting their commitment to "the highest ethical standards" just weeks before the company went under and Mr. Lay was indicted for fraud and securities violations. Likewise, Saytam Computer Service, the behemoth Indian tech services company, was found to have committed a $1 billion fraud in March of 2009, yet it received an award for "excellence in corporate governance" just the month before. The firm Global Compliance, which operates whistleblower hotlines for thousands of companies worldwide, reports that many companies "did little more than check the boxes on ethics…abiding by the letter of the law by publishing codes of conduct without really changing the culture of the company…"

In spite of increasing industry attention to the value of ethics and compliance programs, many companies have chosen not to go beyond those minimum codes of ethics provisions contained in SOX. It is somewhat ironic that individuals and companies at the heart of today's most egregious corporate scandals often obeyed the letter of the law or government regulations, but not the spirit in which those rules were intended. For example, Lehman Brothers and AIG made business decisions regarding their mortgage derivative and insurance businesses that almost brought down the entire U.S. economy; most of these actions were legal under prevailing laws, but most would agree that the actions of these companies were highly unethical and irresponsible.

One explanation for the reluctance of some companies to move beyond minimum requirements is that ethics developments in U.S. industry have been largely rule-based. Often managed by corporate legal departments, ethics and compliance programs (with the emphasis on ***compliance***) have focused largely on implementing statutory requirements rather than highlighting corporate values and ethical decision-making. It follows that corporate ethics training would then be focused largely on legal obligations versus ethical considerations. Even the Federal Sentencing Guidelines emphasize the "prevention and detection of criminal conduct" rather than the creation of an ethical culture within a company.

There are signs that all this might be changing. In 2008 for the first time, every deferred or non-prosecution agreement between U.S. corporations and DOJ required the business to adopt ethics and compliance reforms geared toward improving the ethical culture of the company. In addition, proposed 2010 amendments to the Federal Sentencing Guidelines add requirements on promoting an ethical culture; conducting independent assessments; and ensuring independent reporting of Ethics officials to high level personnel and a company's Board of Directors. [16]

"THE ETHICAL ENTERPRISE"

[16] US Sentencing Commission, Proposed 2010 Guideline Amendments, January 21, 2010. (www.ussc.gov)

A 2005 study by the American Management Association (AMA) and Human Resources Institute (HRI)[17] provides a critical analysis into what drives ethical corporate behavior. Although the survey and study was conducted over 5 years ago, my own recent research and observations of business ethics and compliance activities at U.S. corporations finds this study to be remarkably accurate, insightful, and predictive of future trends and developments in the ethics and compliance arena.

The AMA/HRI surveyed executives and managers in the fields of general management, human resources, and operations functions. More than half of the 1,121 respondents were from the U.S., 25% from Canada, and the remainder from Europe, Asia, and other locations worldwide. The survey asked a number of questions about the importance of business ethics to the organization; what drives unethical behavior (both today and in the next 10 years); what business practices contribute to an ethical corporate culture; and how the effectiveness of ethics programs can be assessed.

When asked about the importance of business ethics to the organization, the survey found that ***protecting the company's reputation*** was seen as the top reason for running a business in an ethical way. Other factors most frequently cited included the perspective that doing things ethically is "***the right thing to do";*** maintaining ***customer trust and loyalty*** and ***investor confidence*** depended on the company's ethical behavior; and a view that ethical behavior had a ***positive impact on financial results.*** In addition, survey respondents indicated that ***worker retention and performance*** were expected to become an even more critical reason to act ethically in the coming years.

Survey respondents also cited a number of environment drivers that impact the way they approach business ethics. "***Pain avoidance"*** was cited as the top-rated environmental driver; the recent history of corporate scandals, the threat of public excoriation, and the prospect of potential jail time for convicted executives all serve as powerful motivators for companies to execute an aggressive ethics and compliance program. Other most frequently cited environmental drivers included

- ***Globalization*** and the resulting increase in market competition, where an organization's business practices become increasingly transparent and important to consumer and partner trust. Consumers and business partners want to avoid "guilt by association", particularly in the areas of child labor, kickbacks, and bribes
- ***Demands by Investors*** ranks among the top five drivers, both presently and into the future. It is a proven fact that scandals and bad publicity drive down stock prices.
- ***Employees*** will increasingly demand ethical behavior on the part of their companies, particularly if the predicted shortage of skilled and talented workers in many industries continues to materialize. People want to feel good about their employers and be part of a team that conducts its business ethically.

[17] "The Ethical Enterprise", A Global Study of Business Ethics 2005-2015, American Management Association, 2005.

When asked about external drivers of business ethics, respondents clearly communicated that the rule of law continues to be viewed as the primary driver in ethical business practices. For example, SOX has dramatically increased the transparency of corporate financial records in the U.S., and the new FAR mandatory fraud disclosure and reporting requirements will increase the transparency of illegal activities, and subsequent corporate response, that occur on contracts with the U.S. Government.

Peaking into the future, the survey respondents predicted (in 2005) that both “corporate social responsibility” and “environmental issues” will become increasingly important over the next decade (they already have over the last 5 years). Organizations predict that their customers and business partners will demand attention to corporate responsibility in an increasingly competitive global economy. (Many major U.S. companies have now included their ethics and compliance activities under the broader umbrella of a senior executive responsible for “corporate responsibility”, which often includes diversity, employee safety, and environmental issues).

Perhaps one of the most revealing (and helpful) findings of the AMA/HRI study is in the area of what drives unethical behavior. Seventy percent of the survey respondents indicated that pressure from management or the Board to “***meet unrealistic business objectives”*** is the leading factor most likely to cause unethical behavior within a company. As described in the report, it is tempting for executives at all levels to “bend the rules” to achieve the desired or mandated business results. That pressure to perform can cascade down the corporate hierarchy, with executives pushing their subordinates to meet objectives that they may believe can only be met by cutting ethical corners.

Working in an environment with “cynicism or diminished morale” was the next most cited factor leading to unethical behavior (31 percent). This view recognizes the fact that people adapt to the values and normal behaviors of their most immediate work environment. Tools such as employee attitude and ethics surveys, ethics help lines, and employee assistance programs are invaluable to assessing and ultimately fixing unhealthy corporate work environments.

The study also found that the “ambitious and the afraid” were more likely to violate a company’s ethical standards. Thirty-nine percent of respondents indicated that ethical violations most often occur in an attempt to further one’s career; another 34 percent believe that unethical decisions and actions take place when employees are trying to save their jobs and protect their own livelihood.

THE IMPORTANCE OF ETHICAL CULTURE

Some of the most significant findings of the AMA/HRI study involve corporate leadership and the extent to which ethical culture is an essential ingredient to the success of corporate ethics and compliance programs. But how does one actually measure ethical culture? In order to gain a better understanding of the state of a company’s ethic culture, the ERC has developed a list of basic elements to examine:[18]

- What are the values that drive “how things are ***really*** done around here?

[18] Ethics Resource Center, www.ethics.org

- How much pressure is there to perform, and to cut corners to do so?
- How confident are employees that executives are committed to ethics as a fundamental to doing business?
- What do employees actually do when they observe misconduct?
- Is there a reason to fear doing the right thing?

The AMA/HRI survey indicates that, rather than being an intangible that cannot be controlled, organizations can establish policies and processes that help create an ethical culture. These include leadership support and modeling of ethical behavior; consistent communication from all leaders; integrating ethics into all corporate processes and strategies; making ethics a part of performance management systems; making ethics a part of the recruitment and employee selection process; and putting measures in place to assess the effectiveness of business ethics programs and strategies.

It is not surprising that the top-ranked process for sustaining a business ethics culture as identified by survey respondents was "***leaders support and model ethical behavior"***. Although it is safe to assume that all public companies officially advocate ethical behavior, the more challenging question is whether leaders at ALL levels "walk the talk". In a 2009 Deloitte LLP Ethics and Workplace Survey, 77 percent of respondents cited the behavior of management or a direct supervisor as the top factor influencing their ethical conduct. [19]

<u>ETHICS AS A BUSINESS IMPERATIVE</u>

Like many laws and regulations designed to create fundamental social, cultural, or market changes, the concept of corporate business ethics and compliance has followed a familiar evolutionary path. Similar to how organizations first implemented laws mandating Equal Employment Opportunity (EEO) in the 1960s, corporate ethics was initially viewed as a "requirement" that could be implemented with minimal effort through the assignment of a collateral duty to a lower-level ethics officer buried deep in the organization chart. Through organizations such as the DII, implementation of the federal sentencing guidelines, and in some cases only after attending the "corporate school of hard knocks", companies began to raise the visibility, role and authority of the ethics function. It has only been in recent years, however, that compliance-based orientation of many ethics programs has evolved into a "values-based" function that is integrated into a company's core business processes.

Today, creating a sound ethical culture and an effective ethics program is viewed as a key to avoiding scandal, safeguarding corporate reputation, and sustaining brand value. Moreover, the development of a recognized world-class ethics program is viewed as a prize that can help a company win in the marketplace, improve its competitive advantage, and achieve higher market valuations. Some companies have finally discovered that not only do resource investments in the ethics and compliance program provide a return on investment, but that "doing the right thing" can actually generate significant business value. For example, Ethisphere Institute reports that its list of the World's Most Ethical Companies (WME) for 2010

[19] 2009 Deloitte LLP Ethics and Workplace Survey (www.deloitte.com)

has consistently outperformed the Standard and Poor's 500 (53 percent return for the WME companies versus 4 percent for the broader S&P) since 2005. [20]

Of course, some hold-out companies may only be convinced by considering the prospects of the 'stick", rather than the "carrot": it is well known that the cost of ethical lapses within companies can be enormously high. The Association of Certified Fraud Examiners (ACFE) examined 959 occupational frauds from 2006-2008. The median loss to companies victimized by fraud was $175,000. More than a quarter of the frauds involved losses of at least $1 million. [21] The cost of ethical lapses to major US corporations that have been prosecuted by the government for their actions (or inactions) has ranged from the hundreds of millions to the billions of dollars.

BUILDING AN ETHICAL FRAMEWORK

So, you're now convinced that a strong ethical culture and an effective, values-based ethics program is the right thing to do, required by law, and a business imperative. But how do you get started in a company that either has no formal program or one that is less than effective? How do you develop a strong, sustainable ethical culture in a company that has lost its ethical identity through a series of mergers and acquisitions? How do you begin to assess the damage and rebuild the reputation of a company that has been publicly exposed and fined for wrongdoing?

Below are several basic questions that a corporate executive should have thoroughly answered in the quest to develop, restore, or maintain an ethical corporate culture[22]:

- **What is the relationship between ethics and other performance metrics in the company**? A company's ethics program should be considered a profit center rather than a cost center, since the cost of preventing a scandal is exponentially lower than the costs of fixing ethical problems. Ethical companies are also more competitive, profitable, and sustaining in the long run.
- **Is our required ethics training more than rote introduction of the company's code of conduct and recitation of laws and regulations?** The most successful ethics training is values based, and moves from theory to practice; from the conceptual to the real. Live case studies can help employees, management, and leadership solve relevant ethical dilemmas as they develop.
- **What is the relationship between exercising sound ethics and retaining great talent?**

  Fortune's top 100 companies to work for contains a wide variety of companies with no obvious common denominator in terms of salary, benefits, career opportunities, profession, etc. The common factor seems to be trust between the employer and the employee. Ethical behavior, as discussed earlier, can lay the groundwork for attracting and retaining the best talent.

[20] Ethisphere Institute, 2010 World's Most Ethical Companies. www.ethics.org
[21] ACFE, Report to the Nation on Occupational Fraud and Abuse, 2008.
[22] Krause, Thomas R. and Voss, Paul J. "Building an Ethical Framework." The Corporate Responsibility Officer, 2008.

- **Have we conducted a risk assessment to determine our exposure to major ethical damage? What is our potential Enron?** Each company has its own “ethical nightmare” scenario, but most face similar ethical exposures (theft, accounting irregularities, kickbacks, FCPA or ITAR violations, etc). Companies should examine the potential hazards of perverse incentives that focus solely on financial goals, and the various unintended consequences of management expectations.
- **What tone should executive leadership set regarding ethics, integrity, and transparency?** What leaders say, think, and feel affects the tone, as does their actions. Mistrust, cynicism, or indifference can erode loyalty to the organization and push truly ethical leaders out the door.
- **What does management need from the Board of Directors and senior leadership to enhance and buttress corporate ethics?** Employees who view the Board and executive leadership as unconcerned will discount any directives about ethics and integrity that might come from the. Consistency and authenticity from the Board and senior executives (often expressed in terms of time, talent, and resources) is essential to success.
- **Who is driving ethics and compliance in the company?** Companies need to designate key, senior internal drivers who develop the agenda, initiate the discussions, create the training, and ensure full participation. A Chief Ethics and Compliance Officer (CECO) should be named who is a full member of the executive management team, participates in major company decisions, and has a singular focus on ethics and compliance. The CECO should have a direct reporting line to the Board of Directors as well as the CEO.
- **Is there consistency of message between and among the Board, the CEO, the senior executive team, and the employees in terms of ethical culture?** The company needs to utilize a common vocabulary, consistency of tone and guidance, and implement systems of rewards and sanctions (including recognition of ethics goals in performance appraisals and compensation packages) to demonstrate the seriousness of intent and authenticity of the ethics commitment.
- **Are there any roadblocks that discourage honest conversations on ethics and the implementation of ethical practices?** Employee perceptions need to be examined on a regular basis (through surveys, focus groups, and internal/external assessments), and the company needs to be willing to make substantive changes based on the results.

A NEW GOVERNMENT/INDUSTRY ETHICS AND COMPLIANCE PARADIGM

As discussed earlier, the U.S. Government has traditionally taken a “law enforcement” approach to business ethics, and industry has responded with rules-based ethics programs that emphasize compliance with applicable laws and regulations. All one has to do is examine the performance metrics for most federal Inspectors General and the Department of Justice: success is measured by completed investigations, prosecutions, convictions, and recoveries. Noble goals such as prevention, transparency, collaboration, and cooperation are rarely mentioned in the business of enforcement. As one senior federal procurement fraud investigator once told me, “lay off a bit on this prevention stuff – I have kids to put through college!”

Several companies have reported asking their agencies or the DOJ for more specific guidance on the mandatory disclosure provisions of the FAR. There is some degree of uncertainty over the thoroughness desired in the company's own internal investigation; the required reporting threshold in terms of materiality; what constitutes timeliness; etc. Reportedly, such advice and clarification has not been consistently forthcoming. Some government officials have apparently responded to such questions by reiterating the sanctions imposed by the FAR for "failure of a company principal to timely disclose" fraud and other illegal acts, which involve suspension or debarment (or even prosecution) of a contractor.

In response, I would ask two questions: Shouldn't it be a very last resort to suspend or debar an industrial partner which the government relies upon to provide critical goods and services (especially when it involves national security)? Wouldn't it make more sense to invest some time and resources up front working with the contractor to clarify requirements and improve their ability to comply?

In the years I have spent as a federal Inspector General, I can report that most of the procurement fraud cases we investigated involved "renegade employees" who violated the company's code of conduct, rather the intentional defrauding of the government by a contractor. Further, most of the more *serious* fraud cases (those involving large sums of money, kickbacks, gratuities, Procurement Integrity Act violations, etc) involved subcontractors, rather than the prime. This was primarily due to weaknesses in the prime contractor's internal controls and oversight, and a virtual absence of a "flow-down" of the prime's ethical culture, code of conduct, ethics training, fraud reporting and hotline processes to the subcontractor.

The new FAR requirements on business ethics and integrity present government agencies with an opportunity to work with their industrial partners to improve the ethical culture in their companies; tighten internal controls and business processes; create a greater degree of transparency through timely disclosure and reporting when bad actors strike; flow-down ethics and compliance requirements to subcontractors and suppliers; and reduce the overall risk to taxpayer dollars executed through contracts.

As stated earlier, the FAR now requires federal agencies to review a contractor's record of integrity and business ethics as part of its "responsible party" determinations during a source selection. At the NRO, we have chosen to meet this requirement by (1) assessing the corporate business ethics and compliance programs of our contractors and subcontractors by applying criteria that addresses requirements contained in the FAR, Federal Sentencing Guidelines, and industry best practices[23], and (2) cross-fertilizing best practices in ethics and compliance activities (including training, communications, rewards and sanctions, organization, etc) between our industrial partners, and (3) working with our contractors to achieve sustainable improvements, when needed, to their ethics and compliance activities, internal controls, fraud reporting procedures, or internal investigative capabilities. We believe that this collaborative approach will help companies maximize the effectiveness of their ethics and compliance

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[23] Criteria covers the following categories: Ethical leadership; Creation of an Ethical Culture; Internal Controls; Corporate Code of Ethics; Ethics Training; Ethical Behavior Rewards and Sanctions; Anonymous Reporting/Hotline Process; Internal Investigations Capabilities; Mandatory Disclosures to the Office of Inspector General.

efforts, reduce risk, and increase transparency when the inevitable employee misconduct does occur.

FUTURE TRENDS IN BUSINESS ETHICS

The AMA/HRI study discussed in detail earlier in this paper identified several practices/approaches that would likely become a part of what they called the "Composite Perfect Company" (CPC) in 2015.[24] Interestingly, in my reviews of the ethics and compliance programs of approximately 25 companies over the last year, I have seen several these practices successfully adopted and have used them as examples of "best practices" in conversations with other contractors.

- **Board of Directors**: The CPC requires Directors to sign and uphold both the company code of conduct and a specific governance code. Directors participate in ethics workshops that include a "train-the-trainer" certification. The CECO has direct access to the Board and provides unfiltered communications, including information on unethical behavior and resolutions, early warnings, and recommendations for process changes to prevent recurring problems.
- **Suppliers, Customers, and Investors:** Subcontractors and suppliers have a separate code of conduct which is part of the contract. The prime holds the right to audit the sub's practices. The prime provides required training to the subs and suppliers on the code of conduct and the company's expectations. The CPC provides current and prospective customers, as well as shareholders, with clear and complete information on its business ethics and corporate social responsibility programs.
- **Business Ethics Effectiveness Measures:** The leadership team uses measures and indicators to determine if business ethics programs are effective. They use outcomes, rather than output measures (for example, not just the number of people trained and the number of hotline calls received). The entire leadership team is provided ethics goals which must be met. CPC conducts an annual employee survey, an annual ethics audit, and supplier/vendor audits.
- **Code of Conduct:** Employees are required to receive training on the Code and pass a test when hired, and each time they are transferred or promoted. This requirement applies to executives as well. Board members must also pass an exam before they are appointed, and follow the same process annually to retain their positions. Additions have been added to the Code, which are viewed as "ethical imperatives": environmental ethics; cultural sensitivity; disaster avoidance; and preparedness/security.
- **Ethics Committee and Decision Model:** An Ethics Committee (with representatives from employee groups, the Board, customers, and suppliers) reports directly to the CEO and is responsible for reviewing the code of conduct and other ethics program activities for effectiveness. The Ethics survey is expanded to the Board, suppliers,

[24] "The Ethical Enterprise", A Global Study of Business Ethics 2005-2015, American Management Association, 2005. P. 27

customers, and investors to better understand their perspectives and concerns. A formal decision-making model is deployed to address true ethical dilemmas.

- **Effectiveness Measures:** Ethics Audits conducted on a continuous, proactive basis; internal data mining is ongoing to identify violations, malfeasance, etc. All employees have specific ethics goals they are asked to meet. CPC attempts to correlate achievement of ethics goals with employee retention, productivity, cost controls, and customer loyalty.

CONCLUSIONS

Corporate entities in the U.S. today are, in many respects, like small towns or cities: thousands of people working together but coming from different backgrounds, diverse racial and ethnic heritage, varying religious and political views, and the full range of personal priorities and values. Like any city, there is a need for clearly understood laws and rules to govern the population; a sheriff to enforce the laws and investigate violations; and unfortunately, a jail in which to put those who choose to ignore the rules and imperil the community. The question isn't *whether* there will be people who choose to violate the law; human behavior dictates that there will always be those that disobey the established rules. The only variable is how the governing institutions *react* and manage problems once they occur.

In the world of corporate business ethics and compliance programs, the priorities are to create a corporate culture that encourages ethical decision-making; establish a clear and relevant code of conduct; train employees at all levels so they are knowledgeable of what is expected of them; implement sound controls to prevent and detect violations of the code; thoroughly investigate allegations of violations; and deal with misconduct in a consistent, equitable, and fair manner.

While there is not an insignificant number of companies that have been properly prosecuted and held accountable for improper *corporate* actions, my experience is that the vast majority of cases of corporate fraud or illegal acts involve "bad actors" within a company that choose to circumvent rules, regulations, and laws for personal or professional gain. There are a variety of proactive steps that companies should take in order to do their due diligence and create an ethical environment that minimizes the frequency of fraud cases and detects them early. But the greatest single variable impacting a company's ability to navigate this minefield and maintain its reputation as an ethical organization is in the speed, decisiveness, and transparency of its actions once misconduct or illegal activity occurs.

This is where government/industry collaboration can have the greatest impact. The risks inherent in government contracting can be reduced by increased government attention and collaboration with industry on implementing the new FAR requirements in order to strengthen corporate business ethics and compliance activities, and cooperation with industry to ensure full transparency through mandatory disclosure of fraud and other illegal acts to the appropriate government entities.