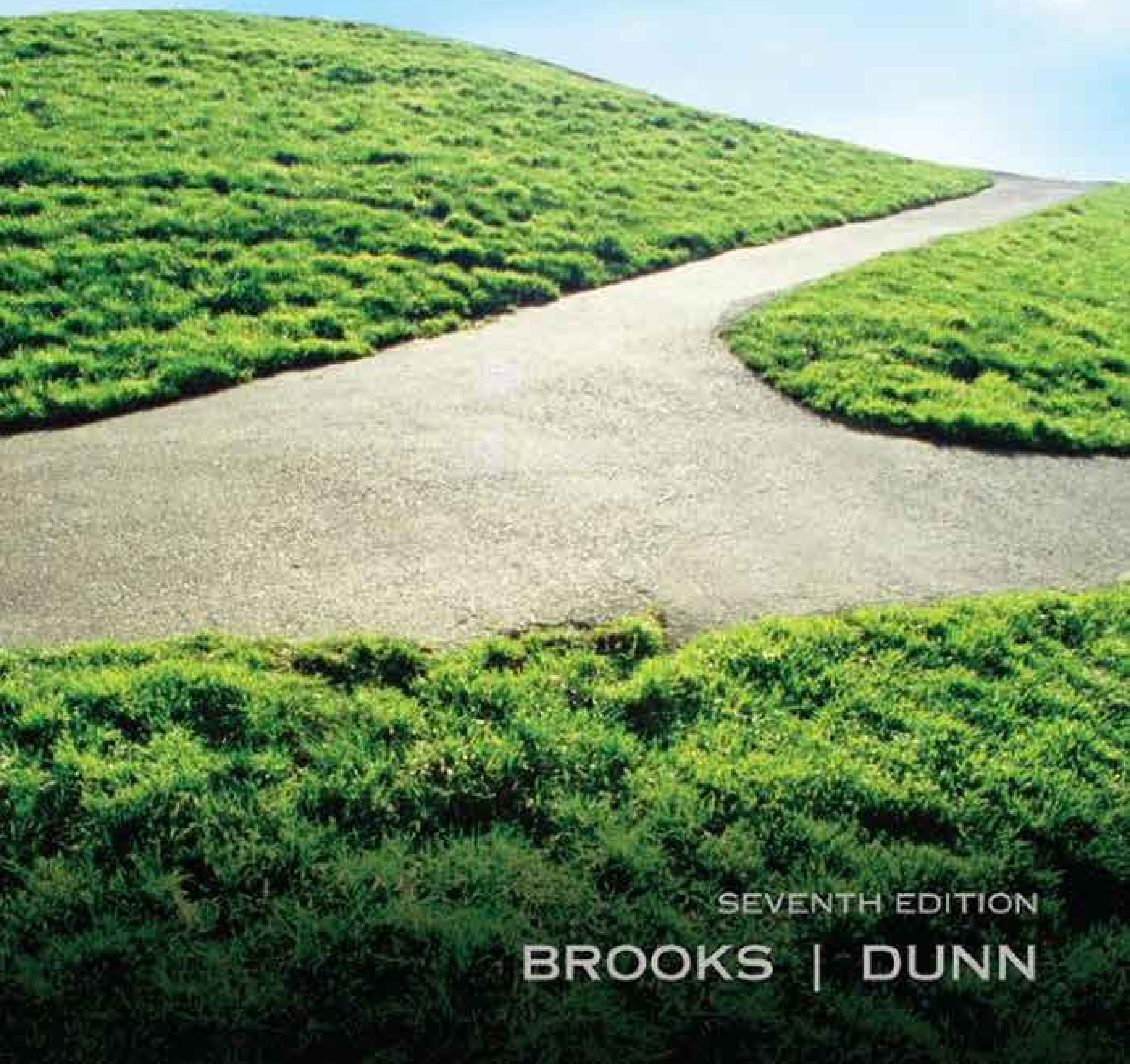
Business & Professional

# ETHICS

## FOR DIRECTORS, EXECUTIVES & ACCOUNTANTS



SEVENTH EDITION

BROOKS | DUNN

# Business & Professional ETHICS

## FOR DIRECTORS, EXECUTIVES & ACCOUNTANTS

SEVENTH EDITION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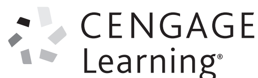


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# DEDICATION

Business & Professional Ethics for Directors, Executives & Accountants *is focused on deepening the understanding of how best to incorporate ethical values into governance, strategies, and actions to the benefit of us all.*

*Our preparation of the Seventh Edition has been enriched by the contributions of many, but none more than our wives and families who have supported and encouraged us, and to whom we dedicate this work. It is with great pride, thankfulness, and love that we acknowledge Jean and Kathy, and our growing families.*

Leonard J. Brooks, FCPA, FCA

Paul Dunn, CPA, CA

Toronto, Canada
*February 2014*

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Professor Brooks served for fourteen years on the Editorial Board of the *Journal of Business Ethics* and continues to serve as a reviewer for that as well as other journals. He has published articles on ethics issues in the *Journal of Business Ethics, Accounting Organizations and Society, Business and Society*, and has authored or coauthored/edited the research monograph *Canadian Corporate Social Performance* and books or publications entitled *Business & Professional Ethics for Accountants, 2e; Principles of Stakeholder Management: The Clarkson Principles;* and *Ethics & Governance: Developing and Maintaining an Ethical Corporate Culture, 4e.*

Before joining the University of Toronto, Professor Brooks obtained his Chartered Accountant (C.A.) designation in Canada and subsequently became an audit manager and Director of Manpower for Touche Ross & Co. (now Deloitte & Touche LLP) in Toronto. He has served as a member, then Chairman, of the CAs' national Board of Examiners, and Chairman of their national Syllabus Committee. Professor Brooks became a Fellow of the Institute of Chartered Accountants of Ontario in 1982 and a Fellow of the Chartered Professional Accountants (FCPA) of Ontario in 2013.

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Dr. Dunn's research focuses on issues in corporate governance, corporate social responsibility, and business ethics. His work has been published in a variety of scholarly journals including the *Journal of Business Ethics, Teaching Business Ethics, The Journal of Management, and Business & Society*. He sits on the editorial boards of the *Journal of Business Ethics and Business & Society*. Professor Dunn is the Treasurer for the Society of Business Ethics, and is also the Treasurer for the Social Issues in Management division of the Academy of Management. He is a frequent media commentator on corporate governance issues, especially the role and function of the board of directors.



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# PREFACE

## CHALLENGES & OPPORTUNITIES

Expectations for appropriate business and professional accounting behavior have changed dramatically. The demise of Enron, Arthur Andersen, and WorldCom triggered the U.S. *Sarbanes-Oxley Act of 2002*. The subprime lending scandal in 2007 led to the worldwide recession that has so significantly negatively affected economies, jobs, and the lives of us all. *These events were ethical failures that could have been prevented.* Unchecked until too late, they subsequently galvanized reforms in the accountability and governance of both corporations and professional accounting that have influenced business and professional ethics around the world. Undoubtedly, they will continue to bring new challenges and opportunities for directors, executives, managers, and professional accountants.

The reforms in accountability and governance frameworks have recognized that corporations and professional accountants have become increasingly more broadly accountable than generally understood. The *crisis of corporate governance and reporting credibility* that Enron began, Arthur Andersen fostered, WorldCom capped, and the *Sarbanes-Oxley Act* (SOX) sought to remedy heightened the awareness that corporations and the accounting profession must have the support of many stakeholder groups to achieve their strategic objectives. Following very quickly, the subprime lending fiasco from 2007 to 2009 further exacerbated the *crisis of confidence* by sensitizing the public and adding to ethical awareness and generating higher expectations for ethical behavior in order to sustain stakeholder support.

That support requires trust. Trust is based on the expectation that the corporation—really its board, executives, employees, and agents—and professional accountant will do the right thing, and that their actions will respect the interests of the stakeholder groups. Earning and maintaining that trust requires changing the strategy, risk management, planning, operations, and decision making of the corporation to take account of the interests and expectations of stakeholder groups in addition to shareholders. A new accountability framework is required that focuses on indicators of performance related to stakeholder expectations for both internal and external reporting.

Governance must focus on this new, broader accountability framework in order to ensure that stakeholder trust objectives are met. Such a change will not happen by itself, and directors are in danger of not fulfilling their expectations to shareholders for risk management and due diligence if they ignore this duty. Some directors have understood the value of an excellent reputation and have been including risks to reputation in their risk management programs. Now that the linkage among ethics, reputation, and trust is clear and better understood, it is vital for corporations to upgrade their accountability and governance frameworks to ensure continued support. Shareholders and other stakeholders have come to expect more than they did pre-SOX—and the bar continues to rise.

Professional accountants can and should provide a critical facilitating element in the trust-oriented accountability and governance system. First, professional accountants can be important agents for ensuring trust. They are expected to serve in the public interest, and must do so to preserve the trust placed in them by a society that expects them to behave as professionals. This expectation, which applies to professional accountants in public practice as well as those employed by corporations, requires a rededication to



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their role as a trusted fiduciary. Second, professional accountants are well placed to understand the role of trust in internal control and accountability frameworks, and in the governance frameworks that provide direction and oversight to corporate activities. Third, good professional accountants are expected to display a level of professional skepticism and duty that should enable them to recognize the red flags of potential problems and report or remediate them.

Perhaps most important, these new governance and ethics expectations have reached the academic launching pads for new directors, executives, and professional accountants. The interest in newly created directors' governance education programs is startling. In 2004, the accreditation body for business schools worldwide published an Ethics Education Task Force Report that called for business students to be educated about (1) the responsibility of business in society, (2) ethical leadership, (3) ethical decision making, and (4) corporate governance and ethics.[1] Moreover, many jurisdictions are requiring compulsory ethics courses for accounting students before they are considered ready to write their qualifying exams for professional accounting designation. Accordingly, ethics and governance coverage is penetrating the curricula of far more business schools than in the past—which bodes well for the future.

Understanding these trust expectations and the interrelationship to ethics and governance will resolve challenges and present opportunities for directors, executives, and professional accountants. More important, it will provide the essential foundation for ensuring their support—and that of corporations—in the future.

## PURPOSE OF THE BOOK

The crisis of corporate reporting credibility became so severe in mid-2002 that drastic measures were required to restore that credibility and relieve the gridlock that froze capital markets and dampened economies around the world. In fact, the financial disasters in 2002 accelerated and crystallized the impact of pressures for enhanced corporate accountability and a supportive governance framework that had been growing for years. As governance reform based on sound ethics takes hold around the world, there is an increasing need to understand the historical precursors involved, the responsibilities expected, and the techniques available for the satisfaction of those expectations.

Telling the story of ongoing pressures for more trusted governance and of the contributions of key financial scandals is important to the development of an appropriate understanding of the post-SOX world for directors, executives, and accountants, and of the heightened ethical expectations arising from the Subprime Lending Crisis. Ethical failures have cost us all dearly. In response, governance has recently incorporated the need for a risk management process - a process that must now be broadened to involve awareness of factors that can erode the support of stakeholder groups.

*The reputation of corporations is recognized as being connected with the degree to which stakeholders trust that corporations will do the right thing*. In other words, there is now *a concern for both what a corporation does and how it is done*. At certain times in the past, the emphasis was so strongly on achieving profit that little attention was given to how the profit was earned. Now that the support of stakeholders is recognized as critical to success, an important second objective of the book is to provide an understanding how to create a corporate *culture of integrity*—one that builds stakeholders' ethical expectations into corporate behavior, accountability, and governance. Extending this discussion to the new era for professional accountants, and reviewing their potential roles, is a third objective.

[1]The Association to Advance Collegiate Schools of Business, *AACSB Ethics Education Task Force Report*, June 2004, available through this book's website at **www.cengagebrain.com**.

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Directors, executives, and accountants need to understand how to make ethical decisions they can defend to stakeholders. Codes of conduct cannot cover all situations, so organizational cultures need to be developed and decision processes utilized that are based on sound ethical decision-making frameworks. *Business & Professional Ethics for Directors, Executives & Accountants* covers these topics as well as the development of an *ethics risk management process*, strategies for dealing with and reporting to stakeholders, and strategies for ensuring ethical behavior in the workplace and during the management of crises.

In a nutshell, *Business & Professional Ethics for Directors, Executives & Accountants* examines the background and nature of the new stakeholder-support era of corporate and professional accountability and governance and provides insights into the development of sound patterns of behavior on the part of directors, executives, and accountants. Successful management of ethical risks and the development of ethical competitive advantages depend upon the mastery of the subjects discussed. Professional accountants must understand the issues covered as a foundation for the fulfillment of their role as fiduciaries and experts in accountability and governance.

## APPLICABILITY

*Business & Professional Ethics for Directors, Executives & Accountants* is intended as a sourcebook for directors, executives, and professional accountants on accountability and governance, on appropriate decision making and behavior, and on ethics risk management in the new era that occurred as a result of the 2007 economic crisis. Blending text, readings, and cases, it can be used as or for the following:

- A stand-alone book in courses in business and/or professional ethics, and/or in governance.
- An adjunct to traditional strategy, governance or accounting texts to provide access to interesting, real-world dilemmas. The material in the book has been used very successfully with MBA and Executive MBA students as well as accounting students.
- Custom selections from the text, cases, and readings can be tailored to specific course requirements, or
- Independent study.

The book has been organized into relatively freestanding chapters to facilitate custom publishing of a selection of chapters and/or cases. For example, material in Chapter 2 could be used to introduce governance and provide a historical path to current thinking on reputational issues and stakeholder support. The history of ethics and governance scandals since 2001, which appears in Chapter 2, has been well used to start off Executive MBA programs. Similarly, directors and executives or MBA students wishing to focus on conflict of interests could benefit from Chapters 2, 5, and 7, plus cases from other chapters. Chapters 1 and 4 provide a fundamental platform for understanding current business ethics expectations, and defensible approaches to ethical decision making for business students beginning their studies. Chapter 8, which covers the subprime lending fiasco, provides an essential understanding of the current business challenge gripping us all worldwide. Professional accounting students should be familiar with all chapters.

The coverage provided is largely North American in orientation. Examples, readings, and cases are drawn with that perspective in mind. Basic ethical problems and principles are the same throughout North America, since they are shaped by the same concerns, markets, and similar institutional structures, and legal strictures. Where points of difference are noteworthy,

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they are dealt with specifically. It should be noted that the increasing globalization of capital markets has extended North American expectations and problems to large companies around the world. Several cases covering problems of large European companies and doing business abroad are included to provide a global perspective.

Because of the prominence of American capital markets and the significant impact of the American practices of the Big Four professional accounting firms, North American governance frameworks for both business and professional accountants around the world will serve as a benchmark for developments in other jurisdictions. In addition, domestic and foreign expectations for behavior will be increasingly intertwined because the practices of multinational corporations or firms will be increasingly scrutinized globally by stakeholders active in major consumer and capital markets and in regulatory arenas around the world.

Ethical behavior in international operations and international accountability are specifically explored because differing cultures call for somewhat different ethical behavior. In addition, the recent emergence of global ethical accounting standards under the auspices of the International Federation of Accountants (IFAC) is covered extensively to prepare readers for the global harmonization process that is occurring.

## AUTHORS' APPROACH

To the greatest extent possible, *Business & Professional Ethics for Directors, Executives & Accountants* focuses on the development of a practical understanding of the ethical issues driving recent unethical events, the resulting development of emerging accountability and governance frameworks, and of the practical skills required to deal with them effectively. Of necessity, this means providing a learning experience embedded with real-life cases and examples. At the same time, these real-life problems are interpreted through exposure to classic positions and articles that have had a lasting impact on business ethics in general and accounting ethics in particular. The authors' experiences as directors, executives, and professional accountants, plus substantial experience in the teaching of and consulting on business and accounting ethics, management control, and similar governance-related subjects, contribute significantly to the development of the issues and discussions offered.

## ORGANIZATION OF THE BOOK, RESOURCE WEBSITE, & WEB-ARCHIVE

The book is arranged in eight chapters that include 124 cases, of which 13 are new to this edition, as well as 6 readings and appendices.

| | | CASES | READINGS & APPENDICES |
|---|---|---|---|
| Chapter 1 | Ethics Expectations | 14 | 2 |
| Chapter 2 | Ethics & Governance Scandals | 6 | |
| Chapter 3 | Philosophers' Contributions | 8 | |
| Chapter 4 | Practical Ethical Decision Making | 11 | |
| Chapter 5 | Corporate Ethical Governance & Accountability | 26 | 1 |
| Chapter 6 | Professional Accounting in the Public Interest, Post-Enron | 34 | 1 |
| Chapter 7 | Managing Ethics Ricks & Opportunities | 17 | 2 |
| Chapter 8 | Subprime Lending Fiasco—Ethics Issues | 8 | |
| | | 124 | 6 |

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The first two chapters provide an understanding of concerns that have been driving the development of current ethics expectations.

- Chapter 1 provides an overview of the book as it deals with the origins of concerns traditionally felt by a range of stakeholder groups, and how these concerns have produced a broadened stakeholder-oriented accountability expectation.
- Chapter 2 provides a historical perspective on the ethics and governance scandals that stimulated changes in ethics expectations for accountability and governance reform, and how these changes have been crystallized in law or generally accepted standards of performance. Both chapters provide a useful foundation for the rest of the book.

The next two chapters facilitate how a director, executive, employee, or professional accountant should respond to the emerging ethical expectations by taking decisions and actions that will be considered both right and defensible particularly when codes of conduct do not precisely fit the circumstances. It presents both concepts developed over the centuries by philosophers as well as practical frameworks for their application.

- Chapter 3 covers important contributions by several philosophers to provide a background from which to reason ethically.
- Chapter 4 presents several practical approaches to ethical decision making—the core of ethical behavior—that facilitate the development of strategy as well as day-to-day decisions business people must face.

Chapters 5 and 6 examine how corporations and professional accountants can develop sound ethical accountability, governance, and management systems that respond to emerging ethics expectations.

- Chapter 5 covers those issues, expectations, and ethical culture-promoting systems that directors and executives should understand in order to discharge their duties successfully in the modern era.
- Chapter 6 deals with the roles and functions of professional accountants in the new accountability system for corporations, as agents of ethical accountability, as experts in the development of ethical accountability and governance mechanisms, and as professionals who should be demonstrating professional skepticism. Chapters 5 and 6 both cover the identification, assessment, and management of *conflicts of interest*, and other key elements of a modern ethics-oriented governance system.

The final two chapters deal with a set of extremely important issues that directors, executives, and professional accountants need to understand and develop a facility with in order to avoid serious pitfalls and to take unique opportunities that others will miss. The last chapters of the book provide overviews of the most pressing and formative ethical and economic problems of our lifetimes and offer guidance as to the lessons that we all should learn.

- Chapter 7 deals with the supercritical areas of: ethics risk and opportunity management, effective stakeholder management, corporate social responsibility performance and reporting, workplace ethics, whistleblower programs and ethics inquiry services, motivation and avoidance of fraud and white collar crime, bribery and the challenges of international operations including cultural networking practices such as *guanxi*, and ethical crisis management.
- Chapter 8 reviews the *subprime lending fiasco* and presents an ethical analysis of this latest ethical disaster to influence the world negatively. Lessons drawn from the

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ethical analysis are presented to provide a platform for discussion and learning so that future problems can be avoided. In its own way, this chapter provides a summary application of the material covered in earlier chapters.

Each chapter presents an interesting selection of cases and a useful list of references. The combination of text, 124 cases, 3 readings and 3 appendices provides a much richer learning experience than books that present just cases, or text plus a limited number of cases and no seminal readings.

In addition, numerous references are made in the margin where a website link/reference or a downloadable file is available on the *Business & Professional Ethics for Directors, Executives & Accountants* (*BPE*) website at **www.cengagebrain.com**. The *BPE* website is updated continuously with new information, notes, and website links of interest.

Finally, a *BPE Web-archive* has been created at **www.cengagebrain.com** to house cases and relevant chapter material that has been shifted to it. For example, cases deleted from past editions, and *Chapter 9: The Credibility Crisis—Enron, WorldCom, & SOX* from the sixth edition have been relocated to the archive to provide a resource for students and instructors.

## IMPROVEMENTS TO THE SEVENTH EDITION

Building on the strong foundation developed in the earlier six editions, this new edition has been thoroughly updated. Major improvements include:

- Helpful videos for cases and other developments are identified in the cases or on the **www.cengagebrain.com** website for students and for instructors.
- Chapter 1, "Ethics Expectations," has been updated to reflect the revisions made to the other chapters of the textbook, and two new cases have been added.
- Chapter 2, "Ethics & Governance Scandals," has been extended to provide a timeline, analysis, and summary of the significant ethics and governance scandals, events, and responses in three time frames: prior to 1970, 1970-1990, and 1990-present. Two key cases are provided covering the Wal-Mart Bribery in Mexico, and the LIBOR rate manipulations.
- Chapter 3 has been updated with the addition of one new case.
- Chapter 4 has been extensively modified to approach practical ethical decision making more directly, and with greater clarity. Virtue ethics has been more fully integrated within the challenges that must be made of prospective actions.
- In Chapter 5, "Corporate Ethical Governance & Accountability," there are five new cases and updates and new material covering:
  - Corporate governance and responsibilities
  - Compelling recent evidence for the development of an ethical corporate culture
  - The development and application of codes of conduct
  - The necessity and nature of ethical leadership, and
  - Corporate psychopaths—their impact and characteristics
- In Chapter 6, "Professional Accounting in the Public Interest, Post-Enron," five new cases have been added as well as new material covering:
  - Transfer Pricing to Artificially Reduce Tax—the Apple Case, and
  - The increasing need for moral courage

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- Chapter 7, "Managing Ethics Risk & Opportunities," has been updated and expanded to include new material on:
  - Ethics Risks—their definition, identification, assessment, and management
  - Corporate social responsibility—an extensive update, and a new Appendix of important sources of CSR, ESG (Environmental, Social, and Governance) and sustainability reports.
  - Bribery—a section on the new anti-bribery regime that is unfolding focuses on worldwide bribery
  - Whistleblower and inquiry services—a new section on this important area
  - Two new cases on sexual abuse and its aftermath.
- Chapter 8 has been updated to take account of recent analyses, and to elaborate on the impact of Credit Default Swaps (CDOs), the spread of subprime lending crisis around the world, the beginning of prosecutions of investment banks and their officers, as well as comment on the possible impact of corporate psychopaths. Two new cases have been added.
- Thirteen new cases have been added to this edition of the textbook.

  Chapter 1 Ethics Expectations
  - Pedophile Priests in the Catholic Church
  - Sexual Abuse by a Penn State Football Coach

  Chapter 2 Ethics & Governance Scandals
  - Wal-Mart Bribery in Mexico
  - LIBOR Manipulations Cause Widespread Impacts

  Chapter 3 Philosophers' Contributions
  - Gender Discrimination at IKEA

  Chapter 5 Corporate Ethical Governance & Accountability
  - SNC-Lavalin Missing Funds Topples CEO & Triggers Investigation

  Chapter 6 Professional Accounting in the Public Interest, Post-Enron
  - KPMG Partner Shares Confidential Information with a Friend
  - Sino-Forest Fraud?—Audit Challenges in China
  - Massive Acquisition Write-Downs in the Mining Industry
  - Auditor's Dilemma
  - Multinationals and Tax Planning

  Chapter 8 Subprime Lending Fiasco—Ethics Issues
  - Questionable Values Produce Resignation at Goldman Sachs
  - Naked Short Selling—Overstock.com Lawsuit Against Goldman Sachs & Merrill Lynch

Importantly, the *BPE* website, **www.cengagebrain.com**, is constantly expanding to include helpful references such as video clips of major events, and brief summaries of key books on ethical matters.

As noted above, a new *BPE Web-archive* has been created at **www.cengagebrain.com** to provide access to cases and Chapter material that has been shifted from past editions to the archive.

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As well, the *BPE Instructor's Manual*, which is available online, has been augmented to provide sample examinations and the discussion of successful, innovative usage of the book by satisfied instructors. PowerPoint's are available for instructors through *the BPE Instructor's Manual* website.


# ACKNOWLEDGMENTS

## By Len Brooks

I have been fortunate to receive excellent suggestions for improving this and earlier versions of *Business & Professional Ethics* from Graham Tucker, Alex Milburn, Bill Langdon, Peter Jackson, Michael Deck, Curtis Verschoor, Lyall Work, and John Grant. But, as in the past, I want to acknowledge specifically the searching and insightful contributions by David Selley and particularly Ross Skinner. In addition, I want to thank Miguel Minutti and Lee Benson, whose research enriched many of the book's cases and discussions. These contributors should rest easy, however, as I did not accept all their suggestions and therefore take responsibility for any errors or omissions.

To my former colleague, Max Clarkson, I owe a debt of gratitude for providing the initial platform and encouragement for development and exercise of my ideas in the classroom and as a consultant, and the stimulation to search for new ideas to contribute to our discipline.

To the Canadian Centre for Ethics & Corporate Policy, I owe appreciation for their willingness to agree to reciprocal use in this edition of material written for *Ethics & Governance: Developing & Maintaining and Ethical Corporate Culture,* 4th edition, which I wrote with David Selley, and which the EthicsCentre published in 2012.

To my mother and my father, who was a CA, CGA, CMA, and CPA, I owe my understanding of values and my interest in pursuing them.

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## By Paul Dunn

To my colleagues who constantly help me explore the numerous aspects of business ethics.

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To my children and their significant others, Megan and Todd, Heather and Josh, and Ryan and Katie, for their encouragement to explore alternative approaches and analyses.

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# THE END OF THE BEGINNING

Amid the tragedy created by the Enron, Arthur Andersen, WorldCom, and the subprime lending fiascos, there is a silver lining—the acceleration and crystallization of stakeholder-oriented accountability and governance frameworks for corporations and professional accountants. The subprime lending fiasco and other ethics scandals have further stimulated these processes. Awareness of these developments, and what they

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require to generate and maintain stakeholder support, provides the foundation for the roles, responsibilities, and future success of directors, executives, and professional accountants. We have entered an era wherein appropriate values upheld and applied hold the key to ethical behavior, reputation, and sustained success. *Business & Professional Ethics for Directors, Executives & Accountants* provides an orderly development of the issues and skills involved and the understanding necessary to use them effectively—hopefully for the benefit of the business community, the accounting profession, and society as a whole.

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# OVERVIEW OF THE BOOK

The disasters at Enron, Arthur Andersen, and WorldCom and more recently the subprime lending crisis have fundamentally changed expectations for the behavior of directors, executives, and professional accountants. Good risk management practices must now incorporate ethics risk management, accountability, and governance practices that ensure the reputations of individuals, corporations, and firms are protected, and that the support of stakeholders is strong enough to facilitate success. Leaving the development of ethical boundaries to trial and error—risking bad practice—is no longer acceptable.

Corporations and business professionals are now part of a new post–*Sarbanes-Oxley Act* era of broadened stakeholder-oriented accountability and governance. Directors, executives, and professional accountants now realize that this necessitates considering the impacts and risks of their decisions on their reputations and on the public interest—certainly on more than the traditional short-term set of shareholder interests. Some businesspeople and professionals will want to go beyond developing a good defensive accountability and governance system to develop a competitive advantage where customers, employees, and others will be attracted by distinctly higher levels of trust based on commonly respected values such as honesty, fairness, compassion, integrity, predictability, and responsibility.

Unless directors, executives, and professional accountants develop effective accountability, governance, and risk management processes that incorporate ethics,

- Directors will be unable to fulfil their due diligence requirements.
- Executives will be unable to develop sound competitive business models and protect their emerging legal liability.
- Professional accountants will be unable to fulfil their role as fiduciaries and as leaders in the development of accountability and governance systems.
- Corporations and the accounting profession as we know them will be further discredited and regulated.

*Business & Professional Ethics for Directors, Executives & Accountants* provides an understanding of why ethics has become a critical success factor, the nature and role of the Enron/Sarbanes-Oxley developments, how ethical behavior can be guided, how ethical decision making can be improved and made defensible, and how special problems—including the subprime lending crisis—facing directors, executives, and the accounting profession can be dealt with. This is accomplished in the following eight chapters:

Ch. 1 Ethics Expectations

Ch. 2 Ethics & Governance Scandals

Ch. 3 Philosophers' Contributions

Ch. 4 Practical Ethical Decision Making

Ch. 5 Corporate Ethical Governance & Accountability

Ch. 6 Professional Accounting in the Public Interest, Post-Enron

Ch. 7 Managing Ethics Risk & Opportunities

Ch. 8 Subprime Lending Fiasco—Ethics Issues



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# 1 Ethics Expectations

## PURPOSE OF THE CHAPTER

Business and the professions function within a framework created by the expectations of the public. Enron and the subsequent Arthur Andersen and WorldCom scandals triggered a "sea change" of new expectations for business governance and the accounting profession around the world. Subsequent scandals—the subprime lending fiasco, the Madoff Ponzi scheme, huge bribery prosecutions, and manipulation of interest rates by major banks—have reinforced the need for new standards and have pushed expectations to even higher levels. Not surprisingly, the newest behavioral expectations are based on an acceleration of business and professional ethics trends that have been long in the making. As a result, business and professional ethics have become key determinants of corporate and personal success, and the focal points of research and corporate change.

This chapter explores the changes that the ethics trends have brought to the expectations framework, as well as the developments that have arisen in response to those changes. It also begins to consider what the changes in expectations mean for the directors, executives, and professional accountants. As such, this chapter provides an introduction and overview of the book.

## THE ETHICS ENVIRONMENT FOR BUSINESS: THE BATTLE FOR CREDIBILITY, REPUTATION & COMPETITIVE ADVANTAGE

During the last 30 years, there has been an increasing expectation that business exists to serve the needs of both shareholders and society. Many people have a "stake" or interest in a business, its activities, and impacts. If the interests of these stakeholders are not respected, then action that is often painful to shareholders, officers, and directors usually occurs. In fact, it is unlikely that businesses or professions can achieve their long-run strategic objectives without the support of key stakeholders, such as shareholders, employees, customers, creditors, suppliers, governments, host communities, and activists.

The support for a business—and business in general—depends on the credibility that stakeholders place in corporate commitments, the company's reputation, and the strength of its competitive advantage. All of these depend on the trust that stakeholders place in a company's activities. Trust, in turn, depends on the values underlying corporate activities.

Stakeholders increasingly expect that a company's activities will respect their values and interests. To a large extent, this respect for stakeholder values and interests determines a corporation's ethical standing and success. Consequently, corporate directors are expected to govern their company ethically, meaning they are to see that their executives,



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employees, and agents act ethically. Moreover, the corporation is increasingly expected to be accountable to stakeholders in a transparent or ethical manner. Performance assessment now extends beyond what is achieved to encompass how ethically those results were achieved.

As a result, the emerging governance and accountability regime for business and the professions has become far more concerned with stakeholder interests and ethical matters than in the past. Directors, executives, and professional accountants, who serve the often-conflicting interests of shareholders directly and the public indirectly, must be aware of the public's new expectations for business and other similar organizations, and must manage their risks accordingly. More than just to serve intellectual curiosity, this awareness must be combined with traditional values and incorporated into a framework for ethical decision making and action. Otherwise, as was the case with the Enron and subprime lending debacles, the credibility, reputation, and competitive advantage of capital markets, the organization, management, professional, and the profession will suffer.

What has produced this change in public expectations for business governance, behavior, and accountability? Several factors appear to share causal responsibility, as indicated in Table 1.1.

## Environmental Concerns

Nothing galvanized early public opinion about the nature of good corporate behavior more than the realization that the public's physical well-being and the well-being of some workers, was being threatened by corporate activity. Initially, concern about air pollution centered on smokestack and exhaust pipe smog, which caused respiratory irritation and disorders. These problems were, however, relatively localized, so that when the neighboring population became sufficiently irate, local politicians were able and generally willing to draft controlling regulation, although effective enforcement was by no means assured.

**TABLE 1.1 Factors Affecting Public Expectations for Business Behaviour**

| | |
|---|---|
| Unbridled greed | Subprime lending fiasco, CEO over-compensation |
| Physical | Quality of air and water, safety |
| Moral | Desire for fairness and equity at home and abroad |
| Bad judgments | Operating mistakes, executive compensation |
| Activist stakeholders | Ethical investors, consumers, environmentalists |
| Environmental Reality | Environmental degeneration, need for sustainability |
| Economic | Weakness, pressure to survive, to falsify |
| Competition | Global pressures |
| Financial malfeasance | Numerous scandals, victims, greed |
| Governance failures | Recognition that good governance & ethics risk assessment matter |
| Accountability | Desire for transparency, corporate social responsibility (CSR) |
| Synergy | Publicity, successful changes |
| Institutional reinforcement | New laws—environment, whistle-blowing, recalls, *U.S. Sentencing Guidelines,* OECD anti-bribery regime, *Sarbanes-Oxley Act* (SOX) reforms, professional accounting reform, globalization of standards (IFAC, IFRS) and principles (Caux), *Dodd-Frank Wall Street Reform* & *Consumer Protection Act* |

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Two other problems associated with air pollution that were slower to be recognized were acid rain, which neutered lakes and defoliated trees, and the dissipation of the earth's ozone layer. In the first case, the sulfur in exhaust gases combined with rain and fell to the ground far away from the source, often in other legal jurisdictions. Consequently, the reaction by politicians in the source jurisdiction was predictably slow, and many arguments were raised about who was responsible and whether the damage was real or not. Ultimately, however, the level of awareness of the problem became sufficiently widespread to support international treaties and more stringent local regulations.

The dissipation of the earth's ozone layer has been more recently recognized as a serious threat to our physical well-being. The release into the atmosphere of chlorofluorocarbon (CFC), once the most common residential and industrial refrigerant, allows CFC molecules to use up molecules of ozone. At the same time, cutting down rain forests in Brazil, a main source for replenishing ozone, has contributed further to the depletion of the ozone layer around our planet. This layer was our major barrier from the sun's ultraviolet rays, which cause skin cancer and damage our eyes.

The timing of the recognition of water pollution as a problem worthy of action has paralleled the concern about our depleted ozone layer, partly because of our limited ability to measure minute concentrations of toxins and our inability to understand the precise nature of the risk of water-borne metals and dioxins. Corporations asserted that they did not have the technical solutions to the elimination of air and water pollution at reasonable cost and therefore could not do so and remain competitive. However, once the short- and long-term threats to personal safety were understood, the public, led by special interest groups, began to pressure companies as well as governments directly to improve safety standards for corporate emissions.

Government reaction, often prompted by disasters, has been significant at all levels. Locally, no-smoking regulations have been enacted and local ordinances tightened. Environmental regulation has been the subject of international treaties. U.S., U.K., and Canadian environmental protection acts have been put in place that feature significant fines of up to $1 to $2 million per day for a corporation convicted of environmental malfeasance. In addition, personal fines and/or jail terms for officers and directors have focused the attention of executives on programs to ensure compliance with environmental standards. Nothing has energized executives in the United States and Canada more than the statement of a judge in regard to the promulgation of the *U.S. Sentencing Guidelines* on November 1, 1991. He said that the "demonstrated presence of an effective program of environmental protection would constitute an adequate 'due diligence' defense which could reduce the level of fine from $2 million/day to $50,000/day." Although this reaction may be viewed as defensive, the "due diligence" movement should be viewed as the *codification phase* of the movement toward corporate environmental responsibility.

## Moral Sensitivity

During the 1980s and 1990s, there was a significant increase in the sensitivity to the lack of fairness and to discrepancies in equitable treatment normally afforded to individuals and groups in society. Increased recognition of the plight of several groups was responsible for this heightened social conscience, including the feminist movement, the mentally and physically challenged, native people, and minorities. To some degree, the public was prepared to entertain the concerns of these groups because unfortunate events had brought the realization that some special interest groups were worth listening to, as environmentalists, consumer advocates, and anti-apartheid supporters had shown. Also, for most of the period from 1960 onward, disposable incomes and leisure time have been

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sufficiently high to allow members of the public to focus on issues beyond earning their livelihood. In addition, as a result of advances in satellite communications that have allowed virtually "live" coverage of worldwide problems, the thinking of the North American public has become less inner-directed and parochial, and more sensitive to problems featured by wide-ranging investigative reporters.

Evidence of public pressure for more fairness and equity is readily available. The desire for equity in employment has resulted in laws, regulations, compliance conditions in contracts, and affirmative action programs in corporations. Pay equity programs have begun to appear to readjust the discrepancy between the pay scales for men and women. Consumer protection legislation has tightened to the point that the old philosophy of "buyer beware," which tended to protect the large corporation, has become "vendor beware," which favors the individual consumer. Employee drug tests have been much more carefully handled to minimize the prospect of false findings. All of these are examples in which public pressure has brought about institutional changes through legislatures or courts for more fairness and equity and less discrimination, and therefore will be virtually impossible to reverse. Indeed, the trend is unmistakable.

Moral sensitivity is evident to international issues as well as domestic. The campaign to boycott buying from corporations that engage in child or sweatshop labor in foreign countries provides ample testimony to this and has resulted in the creation of codes of ethical practice for suppliers, and compliance mechanisms to ensure they are followed. Organizations such as the Social Accountability International and AccountAbility are developing workplace policies, standards, workplace auditor training programs, and reporting frameworks.

## Bad Judgments & Activist Stakeholders

Directors, executives, and managers are human, and they make mistakes. Sometimes the public or specific groups take offense at these instances of bad judgment and take action to make the directors and management aware that they do not approve. For example, the decision by Shell UK to scuttle the Brent Spar Oil Storage Vessel in a deep part of the ocean rather than take it apart on shore led to demonstrations in support of Greenpeace, which tried to stop the scuttling, and to the boycott of Shell gas stations in Europe. Nestlé products were boycotted in North America and Europe to stop the free distribution of baby formula powder to African mothers who were mixing it with contaminated water, thereby killing their babies. Nike and other companies' products were boycotted through the efforts of concerned individuals and groups to stop the use of sweatshop and child labor, particularly in foreign countries. The recall of Firestone tires was ignited by the media, beginning with a television show in Houston, Texas. North American corporations were extravagantly overpaying their executives—including several above $100 million per annum—or not reducing executive pay when profits declined, so CalPERS, the California Public Employees Pension Fund, called for the establishment of compensation committees consisting of a majority of independent directors. Activist stakeholders were clearly able to make a difference—which most people thought was for the best.

Two other kinds of activists also made their appearance in the late 1980s and early 1990s: ethical consumers and ethical investors. Ethical consumers were interested in buying products and services that were made in ethically acceptable manners. Consequently, books such as *Shopping for a Better World, The Ethical Shopper's Guide*, and *Conscious Consumption* were published in the United States, Canada, and in the United Kingdom. They provided ratings of companies, their affiliates, and their suppliers on different performance dimensions, such as hiring and treatment of women, environmental

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management and performance, charity, progressive staff policies, labor relations, consumer relations, and candor at answering questions. Ethical consumers were then able to "vote with their checkbooks."

Ethical investors took the view that their investments should not only make a reasonable return, but should do so in an ethical manner. Originally pioneered by large pension funds such as CalPERS and The New York City Employees Pension Fund, as well as several church investment funds, the movement has been augmented since the early 1990s by several ethical mutual funds. These ethical mutual funds employ screens that are intended to knock out companies from consideration that are involved in so-called harmful activities—such as producing tobacco products, armaments, or atomic energy, or misusing animals for testing. Alternatively, individuals or mutual funds can invest in companies or in indices of companies that have been screened by an ethical consulting service such as Domini Social Investments (http://www.domini.com/) or MSCI (http://www.msci.com/products/esg/). MSCI (Morgan Stanley Capital International), for example, provides several indices of companies ranked high in sustainability, social responsibility, or environmental performance. A similar index, the Sustainalytics JSI Index (Jantzi Social Index), is available for the top 60 Canadian stocks, as well as screening ESC (Environmental, Social, and Governance) factors for Canadian, U.S., and European stocks. In addition, the FTSE4Good Index has been created for companies listed on the London Stock Exchange. The performance of these indices compares well to those for non-screened stocks in each country. A current list of ethical mutual funds and an update on socially responsible investing (SRI) can be found at the websites of SocialFunds.com (http://www.socialfunds.com) in the United States and the Responsible Investment Association (RIA) in Canada (http://riacanada.ca). Many consultants offer screening services to investors on a fee-for-service basis. The entire field of ethically screened investing has continued to grow.

These developments signal that business decisions are being judged against different standards than before, by groups that have billions of dollars at their disposal. For additional information, contact the Investor Responsibility Research Centre (IRRC) at http://www.irrcinstitute.org/ and similar websites.

## Economic & Competitive Pressures

Although the public's expectations have been affected directly by the factors already discussed, a number of underlying or secondary factors are also at work. For instance, in general, the pace of economic activity slowed during the late 1980s, early 1990s, and just before and after the millennium. This placed corporations and the individuals in them in the position of having to wrestle with "no growth," or shrinking volume scenarios, instead of the expansion that had been the norm. In the 1990s, growing pressure from global competitors and the drive for improved, costly technology shrank profit margins. Absence of growth and shrinking margins led to downsizing to maintain overall profitability and desirability to capital markets. Whether to maintain their jobs, volume-incentive-based earnings, or their company, some people resorted to questionable ethical practices, including falsification of transactions and other records, and the exploitation of the environment or workers. The result has been part of the reason for triggering cases of environmental and/or financial malfeasance.

The development of global markets has led to the manufacture and sourcing of products throughout the world. The accompanying restructuring has been viewed as enabling greater productivity and lower costs with lower rates of domestic employment. Therefore, the pressure on employed individuals to maintain their jobs may not abate as

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production increases. Nor, given greater competition, will greater volume necessarily increase profit, so the pressure on corporations will not abate to levels experienced in the past. In addition, corporations will be unable to rely on a cyclical return to profitability to restore the risk of unethical behavior to former levels. Consequently, it would appear that a return to former risk levels will depend on the institution of new regimes of ethical-behavior management and governance.

## Financial Scandals: The Expectations Gap & the Credibility Gap

There is no doubt that the public has been surprised, stunned, dismayed, and devastated by financial fiascos. The list of recent classic examples would include: Enron, WorldCom, Adelphia, Tyco, HealthSouth, Parmalat, Royal Ahold, Barings Bank, Livent, Bre-X, Madoff, the U.S. subprime lending disaster, and the collusion and manipulation of financial markets by major banks, as well as the slightly older U.S. Savings and Loan bankruptcies and bailout and the bankruptcies of several real estate companies.

As a result of these repeated shocks, the public has become cynical about the financial integrity of corporations, so much so that the term *expectations gap* has been coined to describe the difference between what the public thinks it is getting in audited financial statements and what it is actually getting. The public outrage over repeated financial fiascos has led, in both the United States and Canada, to tighter regulation, higher fines, and investigations into the integrity, independence, and role of the accounting and auditing profession, and more recently of executives and directors.

On a broader basis, continuing financial malfeasance has led to a *crisis of confidence* over corporate reporting and governance. This lack of credibility has spread from financial stewardship to encompass other spheres of corporate activity and has become known as the *credibility gap*. Audit committees and ethics committees, both peopled by a majority of outside directors; the widespread creation of corporate codes of conduct; the increase of corporate reporting designed to promote the integrity of the corporation all, and increasing fines and regulation, testify to the importance being assigned to this crisis.

No longer is it presumed that "whatever company 'X'[1] does is in the best interests of the country." Fiascos related to the environment or to dealings with employees, customers, shareholders, or creditors have put the onus on corporations to manage their affairs more ethically and to demonstrate that they have done so.

Devastated by the sequence of U.S. disasters in 2001 and 2002 involving Enron, Arthur Andersen, and WorldCom, public confidence evaporated in the business community, its financial reporting, and in the accounting profession. In the ensuing crisis of confidence, capital markets were reeling. President George W. Bush and other business leaders strove to restore lost confidence, but their efforts were largely in vain. Finally, in record time, the U.S. Congress and Senate passed the *Sarbanes-Oxley Act of 2002* (SOX) on July 30, 2002. That act provides for the reform of both corporate governance and the accounting profession, first in the United States, then indirectly in Canada and around the world. Further details are provided in the next chapter and in the web-archive for this book at **www.cengagebrain.com**

## Governance Failures & Risk Assessment

The Enron, Arthur Andersen, and WorldCom series of disasters in 2001–2002 made it clear that current existing modes governing companies and reporting on their activities

[1]"Whatever is good for General Motors, is good for the country" was a commonly used statement before 2000.

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were not sufficient to protect investors' interests and, more broadly, the public interest in orderly markets and corporate activities.

Corporate directors have been expected to ensure that their corporations act in the interests of investors and within the range of activity deemed suitable by the societies in which they operate. But in the Enron, WorldCom, and other cases, the oversight by company directors failed to contain the greed of executives, managers, and other employees. These and other companies were out of control, and unacceptable practices resulted. To quote the U.S. Senate's report on the *Role of the Board of Directors in the Collapse of Enron*:

> (1) **Fiduciary Failure.** The Enron Board of Directors failed to safeguard Enron shareholders and contributed to the collapse of the seventh largest public company in the United States, by allowing Enron to engage in high-risk accounting, inappropriate conflict of interest transactions, extensive undisclosed off-the-books activities, and excessive executive compensation. The Board witnessed numerous indications of questionable practices by Enron management over several years, but chose to ignore them to the detriment of Enron shareholders, employees, and business associates.
>
> *Role of the Board of Directors in the Collapse of Enron,*
> U.S. Senate's Permanent Subcommittee on Investigations, 2002, 3.

Clearly, the public was fed up with directors, executives, and others enriching themselves at the public's expense. It was evident that directors and executives were not identifying, assessing, and managing ethics risks in the same manner or depth that they were for other business risks. But the Enron, Arthur Andersen, and WorldCom cases resulted in the bankruptcy of two of the world's largest companies and the disappearance of one of the world's most respected professional accounting firms within a year. This sudden reversal of fortunes, caused by the failure to govern ethics risks, changed the calculus of risk management profoundly. The probability of catastrophic failure caused by unidentified and/or unmanaged ethics risks was undeniably real, and much higher than anyone expected.

Governance reform was perceived as necessary to protect the public interest. Where directors had been expected to assess and make sure that the risks faced by their corporation were properly managed, ethics risks were now seen to be a key aspect of the process. Governance reform to ensure that this would happen was overdue.

## Increased Accountability & Transparency Desired

The lack of trust in corporate processes and activities also spawned the desire for increased accountability and transparency on corporate matters by investors and particularly by other stakeholders. Companies around the world have responded by publishing more information on their websites and free-standing reports on their corporate social responsibility (CSR) performance, including such subjects as environmental, health and safety, philanthropic, and other social impacts. Although some information in these reports is skewed toward management objectives, the advent of external verification and the reaction to misinformation are gradually improving the information content involved. The trend is definitely toward increased non-financial reporting to match the public's growing expectations.

In addition, the realization that *unbridled greed* by executives and/or dominant shareholders lay behind many of the financial scandals that have damaged both investors and other stakeholders has reinforced the desire for more accountability for and transparency of corporate actions. For example, the subprime lending fiasco (see Chapter 8) spawned

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the *Dodd-Frank Act,* which mandated clear disclosures of risks inherent in complex financial instruments, Similarly, examples of outrageous executive compensation and bonuses, even when companies were doing poorly, resulted in a vigorous backlash leading companies to offer shareholders more information on remuneration plans and an opportunity to have a non-binding, but helpful “say-on-pay” input, to the pay-setting process. Likewise, companies like General Motors and investment banks that received bailouts during the subprime lending crisis, found that incredibly large bonuses paid to senior personnel were subject to monitoring, approval, and roll-backs. Contrary to the movie *Wall Street*, unbridled greed is no longer considered good.

## Synergy among Factors & Institutional Reinforcement

Linkages among the factors affecting public expectations for ethical performance have already been identified, but not the extent to which these linkages reinforce each other and add to the public’s desire for action. Few days go by in which the daily newspapers, radio, and television do not feature a financial fiasco, a product safety issue, an environmental problem, or an article on gender equity or discrimination. In aggregate, the result is a cumulative heightening of the public’s awareness of the need for controls on unethical corporate behavior. In addition, there are many examples emerging where business executives did not make the right decision and where ethical consumers or investors acted and were successful in making companies change their practices or improve their governance structures to ensure that future decision processes were more wholesome. The entire ethical consumer and SRI movement has been strengthened by the knowledge that acting on their concerns can make companies and society better, not poorer.

In turn, the public’s awareness impacts politicians, who react by preparing new laws or the tightening of regulations. In effect, the many issues reaching the public’s consciousness result in institutional reinforcement and codification in the laws of the land. The multiplicity of ethical problems receiving exposure is focusing thought on the need for more ethical action, much like a snowball gathering speed as it goes downhill.

One of the most important examples of reactive legislation is the *U.S. Sentencing Guidelines of 1991*. As previously noted, it stimulated significant interest by directors and executives everywhere in North America in whether their companies were providing enough guidance to their personnel about proper behavior. The consequences for not doing so prior to the introduction of the guidelines had been minor since directors and senior officers had rarely been held personally accountable for the actions of their employees, and their companies had been able to escape significant fines.

A second example is the anti-bribery regime spawned by Transparency International’s influence on the Organization for Economic Cooperation and Development (OECD). By late 2013, thirty-four OECD member countries and six additional countries had enacted anti-bribery legislation similar to that of the *U.S. Foreign Corrupt Practices Act* (FCPA), which bans bribery of foreign officials. The new anti-bribery regime is more advanced in that it seeks to facilitate extraterritorial legal action. One of the recent anti-bribery laws, the U.K. *Bribery Act* mandates British enforcement over a corporation’s activities anywhere in the world as long as the company has a presence in the United Kingdom. Also, in 2010, the United States used the FCPA to charge and settle a bribery case for $185 million against Daimler AG, a German company, for bribes to foreign government officials in over 20 countries. A third and perhaps the most significant example of reactive legislation is the *Sarbanes-Oxley Act of 2002* (SOX), which is driving the reform of corporate governance and professional accounting throughout the world. The rationale that generated SOX, its nature, and impact are the subject of Chapter 2.

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The desire for global standards of corporate disclosure, auditing practice, and for uniform ethical behavior by professional accountants has generated international accounting and auditing standards under the auspices of the International Accounting Standards Board (IASB) and the International Federation of Accountants (IFAC). Their creations, the International Financial Reporting Standards (IFRS) and the Code of Ethics for Professional Accountants, are the focal points for harmonization worldwide.

Since 2005, there has also been an increasing degree of interest by business leaders worldwide in the *Principles for Business* put forward by the Caux Round Table, as well as in Caux conferences and recommendations for ethical management practice. The Aspen Institute is a further example of an institution providing ethical leadership insights for corporate leaders. The willingness for corporate and academic leaders to become involved with such institutions is evidence of the interest and relevance of their work.

The movement toward higher levels of corporate accountability and ethical performance is no longer characterized only by leaders who are willing to go out on a limb: it has become mainstream and international.

### Outcomes

Broadly speaking, public expectations have changed to exhibit less tolerance, heightened moral consciousness, and higher expectations of business behavior. In response to this heightening of expectations, a number of watchdogs and advisors have emerged to help or harry the public and business. Organizations such as Greenpeace, Pollution Probe, and Coalition for Environmentally Responsible Economies (CERES, formerly the Sierra Club) now maintain a watching brief on the business–environment interface. Consultants are available to advise corporations and so-called ethical investors on how to screen activities and investments for both profitability and ethical integrity. Mutual funds that specialize in ethical investments have sprung up to service the needs of small investors. Large investor activity has also become evident as many public-sector and not-for-profit pension funds have taken an active interest in the governance of their investee corporations and have presented shareholder resolutions designed to cover their concerns. In the face of all of this interest, politicians have responded by increasing regulations and the fines, and penalties (both personal and corporate) involved for malfeasance. The *credibility gap* has not favored business organizations. Lack of credibility has brought increasing regulation, international standards, as well as mainstream interest, and profound changes in governance and management practices.

## NEW EXPECTATIONS FOR BUSINESS

### New Mandate for Business

The changes in public expectations have triggered, in turn, an evolution in the mandate for business: the laissez-faire, profit-only world of Milton Friedman has given way to the view that business exists to serve society, not the other way around. For some, this may be stating the degree of change too strongly; but even they would concede that the relationship of business to society is one of interdependence where the long-run health of one determines that of the other.

In many forums, Milton Friedman made the following case:

> In a free-enterprise, private property system a corporate executive … has [the] responsibility to make as much money as possible while conforming to the basic

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