ETHICAL RISK MANAGEMENT

The intangible aspect of ethics and the reasonable-doubt concept can be sensitive issues in an anti-fraud strategy. The concept of the ethical accountability is a new liability and correcting the ethics impairment is as imperative as correcting the market value impairment. In this session, you will learn how to reduce your organization’s ethical risk through knowledge, vigilance, management, and caution.

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## Learning Objectives

- **Knowledge**: understand ethics and how a cultural ethic can be incorporated in an organization’s anti-fraud strategy on a permanent and realistic basis.
- **Vigilance**: develop the ability to identify the threats to ethics that evolve in fraud and enforce the safeguard measures available.
- **Management**: be able to face ethical violations with professionalism, and manage the ethical issues with determination and success.
- **Caution**: develop the sense of caution in maintaining the ethical environment in the organization; educate and convince versus control and coerce.

### Introduction

“The current financial crisis has raised questions about the legitimacy of capitalism. **Ethical failures** certainly played a role. While it remains to be seen whether and how many people blatantly broke the law, there are abundant signs of **various forms of potentially unethical behavior**. These include **greed**, unreasonable amounts of **leverage**, subtle forms of **corruption** (such as ratings agencies that appear to have had a **conflict of interest**), complex financial instruments that no one really understood, and herd behavior where people just followed along and **failed to exercise independent judgment**.”

— Extract from the *Centennial Global Business Report*, Harvard Business School, 2008 [emphasis added]

### What’s Ethics?

- **Ethics** is defined as the branch of philosophy that consists in the systematic study of behavior standards that promote:
  - Moral norms that must guide these choices
  - The good toward which the choices must tend
Ethics and Fraud

In the fraud triangle theory developed by Cressey, the findings were that for fraud to be committed the three summits of the fraud triangle must be present: opportunity, pressure, and rationalization.\(^1\) Albrecht went further to bring the fact that integrity or ethics are the controlling variable for fraud to be committed.\(^2\)

Albrecht developed the fraud scale, which demonstrated that when pressure and opportunities are high and personal integrity (ethics) is low, there is more probability that fraud will occur than if pressure and opportunities are low and personal integrity (ethics) is high.

Professor Barbato, Saunders College of Business, Rochester Institute of Technology

Question to Professor Barbato:
“What is the difference between personal ethics and professional ethics?”

Professor Barbato’s Answer:
“I assume the questioner is using the term personal ethics to mean one’s conscience and the term professional ethics to mean adherence to a professional code.

“Typically people have resolved this by drawing a line between their role as a professional and their role as an individual. They often decide to follow a professional code

\(^1\) Donald R. Cressey (April 27, 1919 – July 21, 1987) was an American penologist, sociologist, and criminologist who made innovative contributions to the study of organized crime, prisons, criminology, the sociology of criminal law, white-collar crime.

\(^2\) W. Steve Albrecht is the Andersen Alumni Professor at the Marriott School of Management of Brigham Young University (BYU). He is a former president of the American Accounting Association and was previously president of the Association of Certified Fraud Examiners. He was also formerly an associate dean of the Marriott School of Management.
of ethics when they are acting as a professional even though they may personally disagree.

“For example, accurate financial disclosure is a type of honesty. Financial disclosure within my household might mean that budgeting software is up to date and used regularly, but financial disclosure within my company might mean I need to comply with accounting principles and laws. I can use whatever accounting system I like in my household, as long as the bills get paid. I cannot, however, make up my own accounting system for use in a company, because there are specific traditions and laws to be followed in order to demonstrate that I am truly being honest.”

Ethical Accountability
The accountability of an event or an action is defined as the possibility to assign the responsibility of an offense to an individual, which is already negatively biased. We infer an offense, a breach of standard, law, or regulation.

The problem with ethics is that what is legal is not necessarily ethical and what is not unethical is not necessarily illegal.

- Example 1: It is perfectly legal to impose a financial penalty on an offender regardless of his income, but it might be unethical to do so if he has no means to pay the penalty.

- Example 2: A manager has questionable social behaviors, and uses demotivating language (with no disrespect) with his employees. Ethically, he does not give the right example and adopts unethical behavior. Nothing is illegal in his manners, but yet.

The ethics trends we observe are heavily rule based.
- Criminalization of the breach of ethical standards: managerial positions become dangerous:
  - Criminalization of serious breaches of certain directors’ duties in The Companies and Limited Partnerships Amendment Bill, New Zealand, December 2012
  - Martha Stewart in the ImClone insider trading case. She was convicted of insider trading mainly for lying to investigators about selling some 3,000 shares of ImClone stock, in December of 2001 (online.wsj.com/article/0,,SB107833235519345426,00.html)

- Increase of legal components in Codes of Ethics: complexity: The REALTOR® Code establishes a standard of conduct, which in many respects exceeds basic legal requirements. (www.realtor.org/2013-code-of-ethics-and-arbitration-manual)

- Increase of accountability requirements: reduced agility

- Involve individuals before the organization: mission impossible

**Underlying Issues of the Ethical Accountability**

*Ethics Fundamental Principals*

- Independence: Independence of mind and appearance of independence. The manager can easily lose his independence because:
  - He receives compensation from his employer: will obey him for the salary paid
  - He supervises business units that aren’t directly under his control: out of sight causing leakage of authority.
- Social responsibility: promote and protect the interests of the society (citizens, employees, and shareholders).
• Professional judgment and due diligence: reach the highest level possible of competency to exercise the professional judgment with due diligence and caution.
• Misuse of information: never, and in no way, be associated with the misuse of information directly or indirectly.

Ethical Situation Tests: Detection and Prevention of the Ethical Risk

**Ethical Risk**
• Ethical risk exposes the organization to the reputational risk.
• Reputational loss has no bottom limit in dollars; it could be total and lead to bankruptcy.
• Ethical risk management is now integrated in the daily risk management activities.
• Loss of reputation is far more damaging than a financial loss; few organizations recovered after a scandal (e.g., BP Gulf of Mexico oil spill: BP is responsible for close to $40 billion in fines, cleanup costs, and settlements as a result of the oil spill in 2010, with an additional $16 billion due to the Clean Water Act).

What causes unethical behaviors? We recognize three major causes for unethical behaviors:
• Personal enrichment (greed): Norbourg president Vincent Lacroix, Hollinger president Conrad Black, Worldcom president Bernie Ebbers
• Pressure to meet and exceed profits and performance targets: BMO in 2007, loss of CAD680 million related to its natural gas portfolio; Desjardins fund Fairfield Sentry Ltd with Madoff, USD200 million loss
• Organizational culture of profit and performance at the expense of ethics: Enron, Worldcom, SNC, Nortel

In the risk management activities we oversee only major ethical risks. There are three notable ethical risks:
• Misuse of information
• Conflict of interest
• Bribery

Ethical risk management is mainly about perception:
• A manager must lead by example and make it visible to the employees.
• A manager must regularly question his managerial behavior and correct it if necessary.
• A manager must believe in the deterrence benefits of leading by example.

*Misuse of information* is the use of confidential information accessed through professional networks for personal advantage or for the benefit of third parties against payment.

*Conflict of interest* is being in a position of authority and having professional or personal interests in a structure competing with those of the company you work for, or represent.

*Bribery* is offering, giving, receiving, or soliciting anything of value to influence an official act, and includes:
• Buying influence of the recipient
• Commercial bribery
• Kickbacks
• Bid-rigging schemes
The ethics violations have consequences on the individual, the company, and the immediate social environment:

- The individual faces disciplinary action, which might include dismissal.
- The company has a bigger challenge, since the damage to its reputation or misappropriation of assets can put it into bankruptcy and deprive employees of their work and deprive the community of a source of income.
- The immediate social environment affects sales, transport, housing and nutrition activities, and economic losses.
- The ethical lapses have unexpected effects on the business climate; they can make things very difficult for a particular sector, like the investment market in Montreal following the Norbourg scandal and the commercial paper crisis.

**Prevention**

Prevention of the ethical risk requires an understanding of the different attitudes of managers facing ethical situations. We recognize three attitudes or management styles toward ethics:

- Immoral management = opposition to ethics
- Moral management = acceptance of ethics
- Amoral management = negation of ethics

Immoral management is a management mode not only devoid of principles or ethical precepts, but focused on active and open opposition to all that is ethical. Immoral management deviates from ethical principles. In this perspective, managers who practices it have selfish motives and are only concerned by their own gains or those of their organization.
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If the activities of managers are openly opposed to what is considered ethical, it is assumed that these executives are then able to differentiate between what is right and what is wrong; however, they opt for what is wrong. **This implies that they have a predisposition to break the laws and commit fraud.**

For example, in July 2, 2012, global health care giant GlaxoSmithKline LLC (GSK) pleaded guilty and agreed to pay $3 billion for its criminal and civil liability due to the company’s unlawful promotion of certain prescription drugs, its failure to report certain safety data, and its civil liability for alleged false price reporting practices.

Previously Glaxo was fined $88,000 for the killing of 14 babies during illegal lab vaccine trials conducted between 2007 and 2008 in Argentina.

Moral management is a management mode that complies with high standards of ethical behaviors and professional conduct. It targets success in strict compliance with the limits set by firm ethical precepts. The values are dictated by standards such as fairness, justice, and due process.

The intention is not to make profits at the expense of law and ethics. Moral managers are committed to the letter and spirit of the law; the level of behavior is much higher than what’s required by law.

For example, the pharmaceutical company Merck and Co., after investing millions of dollars in the development of a drug to fight onchocerciasis—a disease plaguing the third world as it affects nearly 18 million people—and having found no government or

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aid agency willing to buy the drug, proposed to provide the drug for free, for perpetuity.

Furthermore, Merck realized that there was no effective mechanism to distribute the drug, and decided to go beyond industry practices and develop and fund a committee to ensure distribution.

Amoral management can be intentional or unintentional. Managers whose *amorality is unintentional* are neither moral nor immoral; they are insensitive to or unaware of the negative impact of their business decisions on other stakeholders. They have no perception or ethical conscience. They live their organizational existence without thinking that their actions have an ethical dimension or aspect.

Amoral managers might be simply careless or insensitive to the consequences of their actions for stakeholders. Their intentions might be good, but they do not realize that their management decisions and their actions can hurt those with whom they transact or interact. Usually the letter of the law is their ethical guide.

A manager whose *amorality is intentional* believes that ethical considerations are personal issues, not business issues. He rejects the idea that business and ethics are combined, and believes that commercial activities go beyond the activities covered by moral judgments. In most cases executives’ amorality is not intentional. A small number of managers still believe that ethics has no role to play in business or in managerial decisions. Examples include:

- The sale of alcoholic beverages and cigarettes is legal, and most managers in these sectors did not
expect their products to raise ethical issues such as alcoholism, deaths due to driving while intoxicated, lung cancer, deteriorating health, and secondhand-smoke hazards.

- Casinos were created to entertain, but became places of dependence for many individuals with gambling addictions, with consequences such as divorce, bankruptcy, and suicide.
- Weapons companies created to provide defensive weapons for nations became mercantile companies selling death and destruction.
- The tobacco companies manipulate cigarettes’ nicotine levels to make smokers dependent, knowing that it is harmful to their health. Despite the damage caused, and the lawsuits lost by multinational tobacco companies, selling cigarettes is still legal.

To read hidden personal behaviors and anticipate wrongful acts, we need to oversee the gap between business ethics and personal ethics.

- Business ethics is about business behavior that promotes human good.
- Personal ethics is about personal behavior that promotes human good.

They should converge, but if they don’t we have a red flag. Other prevention tools are available; they are administrative supervision structures, like the ethics committee. We need to formalize and push for board of directors (BOD) duty in ethics oversight through its committees:

- Use and consult BOD committees:
  - Ethics committee
  - Governance committee
  - Risk committee
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- Audit committee

ETHICS COMMITTEE
- The ethics committee is established by a resolution of the (BOD).
- It is not mandatory, but highly desirable.
- Like all board committees it should be independent.
- The committee’s mandate is to assure the BOD that the organization maintains the highest standards of ethics and corporate governance.
- The committee advises and makes recommendations to the board, in order to have a reasonable assurance with respect to certain sensitive ethical issues such as:
  * The achievement of corporate objectives by the President and Chief Executive Officer
  * Compliance with the mission, vision, strategy leaders
  * Application and monitoring the application of the Code of Ethics

Fundamentals of detection
There are three main areas to look for red flags:
- Decision problems: the rules surrounding the thoughtful choices and their consequences
- Moral principles: good and bad
- Consequences of ethical decisions: values (equality, fairness, impartiality, loyalty, moral right, right to justice)

Decision Problems
These problems come from the difficulty in making decisions that are not supervised by laws and regulations, without having an ethical situation subject to interpretation. For example, when allocating summer holidays, if a manager gives priority to his secretary, it
will look like a preference; if he puts her last, it will look like contempt to her employment group and a preference to other groups. So the manager usually delegates this kind of responsibility, which affects business continuity, and internal control.

**Moral Principles**

Moral problems manifest themselves in different ways from one individual to another, depending on its culture, and lived experiences. It is therefore important to have an ethical standard used by all (code of ethics), to avoid misleading interpretations of morality. For example, offering gifts between businessmen is well considered in some cultures, while in others it is corruption.

**Consequences of Ethical Decisions**

Some ethical decisions cause unethical situations with impacts on the work environment, the productivity of the staff, and sometimes even the company’s survival. For example, the CEO of a company decides to increase the salary of his son for his outstanding performance, justified and documented, but other company executives associate it to the filial relationship. This decision can affect their motivation and trigger negative behaviors.

**Apparent Unethical Situation**

Faced with an apparent failure in ethics, it is important to remember to handle it with great caution, and follow a sequence, considered individually or with others:

- Don’t play solo to solve ethics issues and WATCH THE CONFIDENTIALITY.
- Ask and gather support from:
  - Management support
  - Legal counsel
- Ethics expertise: BOD committees, external experts
- HR
- Gather relevant facts, NOT perceptions.
- Identify ethical issues involved.
- Identify basic principles related to the problem in question.
- Assess internal procedures in place.
- Look for various possible ways of action: simple is also efficient.
- Final solution: Report to the right level indicated in the ethics policy or the code of ethics.

In all cases of breach of ethics, it is essential to keep in mind that the failure might be due to insufficient education or failure to maintain ethical values from the organization—the employee is not the only culprit. Make sure you provide proper training and regular review of ethics.

The most common threat to a manager is the conflict of interest:
- The conflict of interest has the distinction of breaking the criterion of independence in the exercise of managerial functions.
- For example, according to the Code of Ethics of the International Federation of Accountants (IFAC), we need to talk about conflict of interest, rather than independence.
- Independence is too vague; it is difficult to predict all situations of derogation from the principle of independence, just by building regulations.
- The conflict of interest is palpable, easy to identify.

According to the philosopher Michael Davis, the conflict of interest is a situation in which the interest of
a person tends to harm the proper exercise of judgment on behalf of someone else:

- The conflict of interest undermines the informed judgment of the trustee; it creates what Davis calls a “normal risk of error” likely to result in a wrong judgment or a trustee wrong act.
- A conflict of interest is like the dust housed in a sensitive gauge.
- It prevents the gauge from being reliable; you think your fuel tank is full when in reality you are about to run out of fuel.

Conflicts of interest are not of a financial nature exclusively. For example, a judge receives a case where he resents a bias towards the defendant, such as he believes that the defendant obviously cheated others before, because he sold a house with defects to his sister-in-law many years ago. The judge has a conflict of interest.

This example also shows that conflicts of interest are not all motivated by self-interest; in this case, the negative bias without direct evidence is causing the problem rather than a personal gain.

**Potential Versus Real Conflict of Interest**

We cannot always avoid a conflict of interest and it is not necessarily bad:

- What is wrong is not to deal with it adequately and on time.
- Conflicts of interest are more tolerable when they are “potential” rather than “real.” They can also be “apparent” only.

For example, there is an amicable divorce. The parties opt for the least expensive procedure, which is sharing a
lawyer. In such a case we can obviously expect a dispute to arise anyway over the house, the bank account, or the dog. From the outset, the lawyer might be in a situation where any attempt to use his professional judgment for both parties will influence his professional judgment in an unpredictable way.

The lawyer would have a potential conflict of interest as he would agree to represent both parties. But if the divorce remained civilized, there would be no real conflict of interest.

In another example, the judge cited before has a conflict of interest with regards to the judgment, but not yet in the situation where he must make that judgment. The potential conflict of interest will arise if he decides to administer the case. The conflict of interest is real if the judge has a conflict of interest in respect of the judgment and is in the position of having to make that judgment.

The Apparent Conflict of Interest
An apparent conflict of interest exists when there is no conflict (actual or potential), but someone other than the person involved would be justified to conclude (even tentatively) that there is one. An apparent conflict of interest is not a conflict of interest in the strict sense of the term.

An apparent conflict of interest shall be promptly settled by disseminating sufficient information reversing the existence of actual or potential conflict. For example, to respond to a charge of financial interest, we must demonstrate the absence of any link with the interest.
Actual Conflict of Interest
An actual conflict of interest is a situation in which the individual has sufficient knowledge of private interest to influence the performance of his official duties and responsibilities.

The nature of the potential conflict of interest is the notion of predictability. There is potential for conflict when the office holder realizes he has an interest that may be sufficient to influence the exercise of any function or responsibility.

There is an apparent conflict of interest when, from a reasonable, well-informed, third-person perspective, there is reasonable fear of conflict of interest.

Conflict of Interest Safeguards
- Leave, discontinue the situation, or resign.
- Fully disclose the conflict of interest to the parties concerned.
- Request the issuance of an ethics opinion involving an impartial person (referee).

Final Step
Ipsos Reid Survey, July 3, 2013
- Four in ten (42%) employed Canadians have observed some form of workplace misconduct.
- One in five (17%) cite witnessing privacy violations.
- 13% reported witnessing “conflicts of interest” such as insider trading, while 17% witnessed “fraud.”
- The most common form of misconduct was “misuse of company property,” reported by 28% of respondents.
- Less than half (48%) of those who’ve witnessed misconduct have actually reported it.

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Practice Questions
1. You open an email to find a huge file of your company’s HR data that was sent to you in error. You can see how much everyone makes, their performance reports … everything that is pertinent to their employment. So, do you:
   A. Take a quick skim through before notifying the sender?
   B. Close it immediately and notify the sender?

   Is it wrong to look even if you keep the information to yourself?

2. You find that you can examine people’s expenses claims and you see that your boss is cheating for a hundred or so dollars per month. Would you:
   A. Report him if you wouldn’t face any consequences?
   B. Report him, consequences be damned?
   C. Forget about it?

3. Now assume the false claims amount to thousands, not hundreds of dollars. What do you do now? If your answer is different to your answer from question 2, explain.

4. In these tough economic times many people are desperate to get a job. Is it unethical to intentionally and significantly underpay a highly qualified candidate?

5. You “know” you are underpaid. You can pad your expenses and get away with it and in the grand scheme of things, your overbilling would be virtually negligible. Is this wrong? If it isn’t, why not? If it is, why?
6. You discover that a service provider has violated their terms of service and should have refunded some small portion, say a few dollars, of what they charge your organization, but they don’t make a correction on their bill. If you say anything, it’s going to be a huge fuss and could make your life difficult. Do you:
   A. Keep quiet?
   B. Make a fuss?

   If you keep quiet because it’s only a few dollars then how much would it have to be before you took action?

7. If someone tells an offensive joke, is it my responsibility to speak up about it?

8. My boss asked me to cover for him on his expense report by saying I was at a meal when I wasn’t. Should I do it?

9. My boss gave me credit for a project on which a colleague did most of the work. Should I accept the praise?

10. You are part of the team looking for a new CFO. You are down to three candidates and, given the importance of the job, you have the candidates’ backgrounds investigated by a private investigator to see whether there is any dirt on them. Is it ethical to probe their backgrounds like this? If you were the candidate, would that change your answer?

11. Scenario 2 of the previous question: You are part of the team looking for a new CFO. You are down to three candidates and, given the importance of the job, you have the candidates’ backgrounds investigated by a
private investigator to see whether there is any dirt on them. You find that:

A. The first candidate used opium in college, drinks excessive amounts of whisky every day, usually sleeps until noon, and is known to have had two mistresses.

B. The second candidate has been linked to crooked politicians, chain smokes, drinks ten martinis a day, has also had two mistresses, and regularly consults with astrologers.

C. The final candidate is a vegetarian, doesn’t smoke, rarely drinks alcohol, is a decorated war hero, and hasn’t had any mistresses.

Which candidate would you choose and why?

Extract from: Seven ethical questions, Backspin By Mark Gibbs, Network World, March 22, 2010 12:05 AM ET

Extract from: 10 ethical questions, answered, Jeffrey L. Seglin, Real Simple, March 10, 2010 10:24 a.m. EST