



ACCOUNTANTS FOR BUSINESS

Risk and reward: tempering the pursuit of profit

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ABOUT ACCOUNTANTS FOR BUSINESS

ACCA's global programme, Accountants for Business, champions the role of finance professionals in all sectors as true value creators in organisations. Through people, process and professionalism, accountants are central to great performance. They shape business strategy through a deep understanding of financial drivers and seek opportunities for long-term success. By focusing on the critical role professional accountants play in economies at all stages of development around the world, and in diverse organisations, ACCA seeks to highlight and enhance the role the accountancy profession plays in supporting a healthy global economy.

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The pursuit and achievement of profit, whether motivated by individual or corporate ends, does not necessarily correspond with the notion of sustainable 'success'.

The challenge for a responsible business is to find ways to ensure that the rewards it seeks are supported by sensible management of the risks that confront it.

This report discusses the complex issues, particularly the ethical and behavioural factors, which must be addressed.

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Risk and reward: tempering the pursuit of profit

- The verb to temper:
 1. To moderate or control, eg temper your language around children, temper expectations.
 2. To heat-treat a material, turning something brittle into something stronger.
- Recent events have amply demonstrated that profitability can also be brittle. This paper suggests that its pursuit should also be tempered so that it is stronger, and therefore more sustainable, and well controlled.

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Foreword

The financial crisis that began in 2007 has put the spotlight firmly on how corporates, especially those in the financial sector, have addressed issues such as risk, reward, governance and ethics. ACCA and others have argued that failings in these areas played a major part in creating the crisis.

It is clear that risk has not been addressed with sufficient respect or understanding by institutions. The link between risk and the rewards earned by individuals was not given sufficient consideration, and the risk function itself was undervalued, and too far down the corporate pecking order to be effective. Many claim that this has changed since 2007, but questions must still be asked about how genuine and permanent this change is going to be.

Risk can never be eliminated from business, and it would be wrong for regulators or governments to think they can do so. Risk creates opportunities and should be managed, not removed. A balance must be struck between, for example, ensuring that banks are sufficiently capitalised in order to prevent their collapse in a downturn, and avoiding over-cautious requirements which prevent banks going about their socially beneficial business – and that includes lending to businesses.

Now that the global economy appears to be climbing gradually out of downturn, in 2010 at least, it is timely to examine what needs to be done to try to prevent a recurrence of the problems we have seen in recent years. This paper is intended as a contribution to that effort. In it we consider the issue of how companies should approach the management of the many risks that they face, with particular emphasis on the crucial issue of reputational risk.

ACCA has taken a leading commentary role on the financial crisis in the past two years, with papers that include *Corporate Governance and the Credit Crunch* (2008) and *The Future of Financial Regulation* (2009), and this discussion paper has followed a similar process of evolution. We have once again been indebted to the thoughts of a expert group of risk and governance experts in the UK, allied with the input of senior figures in the financial, corporate and accountancy sectors from around the world, sourced through ACCA's global network of national offices. A full list of contributors appears at the end of the paper, and ACCA thanks them all, both for their time and their informative input on this important subject.

The contents of this report represent ACCA's own opinions and conclusions, and do not necessarily represent the views or policies of either the individuals quoted or their employers.

Executive summary

Traditional theories of corporate behaviour suggest that companies and their shareholders are locked into a matrix whereby shareholders are motivated primarily by a desire to make quick returns on their investment and companies are driven, by actual or perceived shareholder pressure, to make the short-term profits that make those investors happy and encourage others of like mind to invest in them. This narrow interpretation of company and (particularly) shareholder motivations still holds good to some degree – the circumstances of the takeover of the UK company Cadbury's in early 2010 suggest as much – and some investors will continue to invest for the short term and seek immediate returns of capital and short-term appreciation of share values. But developments in company law, the regulatory environment and stakeholder engagement are now combining to make it clear that a company which fails – or refuses – to see the fuller picture and the longer-term prospect will not be acting in the best interests either of itself or of its investors.

During the banking crisis, organisations failed which were previously thought to have had leading-edge risk management functions. This means that we need to re-evaluate the whole area of risk management. Its quantitative methods imply more accuracy than may be reasonable; conventional approaches to it are flawed. The usual approach to risks is to address them one-by-one, whereas in practice they tend to constellate. Risks are often considered in isolation from other aspects of the business, whereas they should be balanced against the potential rewards. And risks are usually thought of as particular events, rather than as potential causes which could give rise to a variety of unwanted effects. As in medicine, it makes sense to treat the causes not just the symptoms.

Risk management appears to have risen up the corporate agenda, but this is not always reflected by increased budgets. And while there are reported improvements in risk, governance and controls, much remains to be done. There is also a widespread view in the financial and other sectors that risk will be 'put back in its box' once the crisis passes and normality can resume. This would be a dangerous and regrettable outcome, and regulators are urged to redouble their efforts to monitor firms and encourage the development and implementation of ethical cultures.

The disciplines that governments and regulators impose on businesses continue to increase, particularly in the listed company sector where the onus to protect investor interests is most apparent. With every corporate scandal and regulatory failure that occurs, the call goes out for more regulation. But the fact that such events continue to happen suggests that the correct disciplines are not being applied. There are four possible reasons why this is so.

- There has been a failure to frame regulatory controls in the way which is most likely to achieve the desired regulatory outcomes.
- The process of regulation is seen by the regulated parties as a bureaucratic burden, with no fundamental relevance to the way they conduct their business.
- There is a lack of effective supervision and enforcement of regulatory rules or principles.
- Business has failed to show genuine commitment, not only to complying with the objectives which lie behind externally imposed compliance obligations, but also to the fundamental virtue of acting in a commercially responsible – or ethical – way.

In the development and implementation of ethical standards, there is a place for codes of practice and principles developed by industry groups and regulators, while elected governments are within their rights to impose their own standards of morality on the business community. But we have seen that it can be dangerous to impose on businesses, from above, standards of morality which appear to be well-meant, but which have the potential to conflict with the efficient running of a business. An example is the Clinton administration's efforts to pressurise mortgage providers into facilitating increased home ownership among some of the poorer sections of US society, which led indirectly to the sub-prime crisis. To be effective, ethical practices need to be relevant to the way each business operates, woven into the culture of each and, crucially, adopted by individuals of integrity within the organisation. The lead for this process must come right from the top. Businesses, and where appropriate regulators, should seek to ensure that they acknowledge the desirability of recruiting and developing staff, especially senior executives, directors and financial staff, who have a strong ethical 'compass'. This process should aim to go beyond aiming to merely stay within the law or to comply with a code: we set out some suggestions for this in sections 15 and 16.

While each crisis triggers calls for more regulation, and the 2007 financial crisis is no exception, the unfortunate reality is that regulation often does not work as intended. Although the intention is that people follow the spirit and the letter of requirements, the process of regulation can foster a culture where people will ignore the requirements if they feel they have to. The onus to comply can lead individuals to feel that they do not have to exercise judgment or common sense and self-restraint. ACCA prefers principles to rules, but, for the principles to work well, there needs to be a culture which supports them.

Reporting is helpful in many ways, from the perspective of the organisation itself and of external shareholders and other stakeholders. Quite apart from the benefits of communicating information to the recipients of reports, it helps the preparers of the reports by focusing their minds. Few companies currently have much to say in their reports about their values and how they ensure ethical behaviour. Reporting on such matters would help them to focus on the business benefits of having an ethical culture, and reduce the risk of an ethical lapse and the potential ensuing reputational damage, not to mention the wider economic damage.

1. Introduction

Business entities of all kinds need to make money. Without revenue no business can hope to achieve its aims, whether these are primarily commercial or philanthropic. A business that does not earn money cannot hope to raise finance, make profits, reward investors, invest for the future, meet its corporate and social responsibilities or, last but by no means least, pay its suppliers and staff. If it cannot do any or all of these things, the authorities also stand to suffer from lost tax income, to the disadvantage of all.

The entrepreneurial spirit and the profit motive are thus integral to the successful conduct of business anywhere. The economy, and society as a whole, benefit when businesses carry out their operations successfully. It follows that the encouragement of business activity, at all levels, should be a key aim of public policy in a free market economy.

But with freedom has always come responsibility, and any private enterprise which aims to succeed over the longer term will need to be aware of the various threats and challenges to its viability and adapt its behaviour accordingly. In short, it needs to balance risk and reward.

Business risk takes any number of forms. Starting up a new business is a high-risk exercise in itself – it is estimated that half of all businesses fail within three years. When a company fails, invariably its investors and creditors stand to lose their money; thus, anyone hoping to create a viable business in the long term needs to plan for how it is going to overcome the challenges which they anticipate. Any decision about whether to invest a company's resources in the manufacture of a new product, or its entry into a new market, will invariably need to take into account the prospects of that investment achieving a profitable rate of return, over some specified timescale. And businesses operating in particular markets or market sectors will often face special challenges which need to be identified, understood and assessed. These are strategic and operational matters which a company's management must address as part of responsible business planning.

Other threats and challenges come from the external environment. The law and other forms of regulation invariably impose a wide and growing range of compliance

obligations on businesses, especially large and listed companies. These obligations will often involve companies in a substantial investment in their internal resources and procedures to ensure that neither the business nor its staff incur sanctions for breaching the regulations. Businesses are also increasingly aware of the interest that a wider group of stakeholders now has in their activities. These include not only the company's shareholders and regulators, but also its target market of consumers, the media and the general public. Companies themselves are more conscious than ever before both of the relationship between their image in the market place and consequential consumer behaviour, and of the implications of this relationship for their business prospects.

The global banking crisis which started in 2007 has amply demonstrated the effects of failing to reconcile the management of operational and reputational risk with the pursuit of commercial profit. A number of financial institutions made serious errors in assessing and managing the level of risk inherent in their activities. It has been widely argued that this mismanagement of credit appraisal and operational risk was compounded by the banks' policies on incentives and remuneration, which served directly to encourage the excessive risk that proved so commercially disastrous.

Some institutions subsequently attracted very bad publicity because, having been bailed out by taxpayers in 2008 and 2009, they then awarded very substantial bonuses to some of their staff. This has raised additional questions not only about their handling of reputational risk, but also about the circumstances in which exceptionally generous incentives and remuneration can be consistent with companies' responsibility to act in the best long-term interests of their shareholders and their stakeholders more generally. Furthermore, the crisis has raised the key issue of what role ethical principles can play in acting as a responsible constraint on decision making within the commercial world.

This paper looks at some of the issues involved in striking a balance between the legitimate pursuit of profit and the management of the various influences which bear on a company's business choices and actions.

2. Disciplinary pressures from the external business environment

The actions of companies are invariably subject to a number of disciplinary pressures. Any responsible business, like any responsible individual, will exercise a measure of self-discipline in the way that it plans and manages its affairs. Financial planning, risk management and internal audit will be integral in this regard. Other disciplines will be imposed from above.

The constraining influences on company behaviour imposed from above, ie by law, regulation and market expectation, are founded on the understanding that companies exist in a common environment and their actions have consequences for other actors in that environment. These influences also specifically derive from the protection that society provides to companies in the form of limitation of liability. Society has always sought to provide certain minimum safeguards for those dealing with limited companies in order to compensate them for the risks they run.

The issue of the purpose of the company, and in whose interests it is expected to be run, is key to resolving the issue of how far companies should be required to temper their pursuit of economic profit.

In most jurisdictions, a company's directors will be ultimately accountable for their stewardship of the business to the company's shareholders, ie the people who collectively own the business. Traditionally, directors of commercial companies have regarded satisfying the financial interests of those shareholders as being the guiding aim of their stewardship. In accordance with this 'shareholder primacy' approach, some directors have felt able, or even obliged, to manage their businesses in a way which seeks primarily to maximise shareholder value and satisfy the financial demands of shareholders for regular distributions of capital. Increasingly, this approach has faced the criticism that it encourages companies to pursue economic profit with no systematic concern for the consequences of their actions for other parties.

That restricted concept of the purpose of the company and its relationship with the outside world has, however, been in a state of evolution over recent years. Pure shareholder primacy has largely given way to the realisation that it must always be in the best interests of a company to seek to remain viable in the longer term. And to achieve this goal, it is necessary for its directors to take into account all the factors which might have a bearing on their decisions. That means, at least in part, building and sustaining mutually beneficial relationships with stakeholders of various kinds. The World Business Council for Sustainable Development (WBCSD) puts it thus:

A coherent corporate and social responsibility (CSR) strategy, based on integrity, sound values and a long-term approach, offers clear business benefits to companies and contributes to the well-being of all.

In the UK, although it is still the shareholders who own the company and who appoint its directors, the Companies Act 2006 states that the directors must always have regard, in the decision-making process, to specified factors such as the likely long-term consequences of any decision, the need to foster the company's relationships with suppliers and customers, the impact of the company's operations on the environment, and the desirability of the company maintaining a reputation for high standards of business conduct. Accordingly, a board that makes decisions which pay no regard at all to one or more of these statutory factors will be in breach of its collective duty to the company and will leave itself open to civil action by its shareholders.

So, where this expanded understanding of the interests of the company is enshrined in law, while directors will still be free to make whatever decisions they think fit, the decision-making process should observe certain ground rules; these call on directors to respect the fact that the interests of the company will always and systematically incorporate concern for its stakeholders. Even where the law does not intervene to this effect, any sensible business will wish to make itself aware of all factors and dynamics which may have a bearing on its future prospects, and take them into account in the decision-making process. Arguably, shareholders should also be prepared to insist that their company's directors act in this way in order to protect their collective interests.

More specific controls imposed on companies by the external business environment may include:

- companies legislation
- prudential requirements imposed on financial institutions by legislation or regulation
- compliance and disclosure rules imposed by listing authorities
- financial reporting rules and standards
- internal control requirements, such as those required by legislation, eg the US Sarbanes–Oxley Act
- anti-bribery controls, such as those required by legislation, eg the US Foreign and Corrupt Practices Act, and the UK's Bribery Act 2010
- anti-money laundering controls that are imposed by law or regulation to implement the recommendations of the global Financial Action Task Force (FATF)
- legal or voluntary/quasi-voluntary codes of practice on corporate governance, which will invariably cover matters such as internal audit and risk management
- market-driven codes of practice
- legislative and regulatory requirements which require companies to meet wider social objectives, eg on health and safety and employment
- influence and pressure from NGOs.

All measures of this kind require companies to follow rules, or principles, which aim to reduce the risk that, in their pursuit of profit, the interests of their stakeholders will suffer. The basic rationale of this must be right – society should seek to provide reasonable protections for those who deal with companies, over and above those safeguards which can be enforced by shareholders and other direct stakeholders.

3. What are the main risks that businesses face?

All businesses face a wide variety of risks, some of which come from within the organisation and others from outside. Some can be predicted with reasonable accuracy. For example, a bus company can, from experience, reasonably estimate how many road traffic accidents its buses are likely to be involved in during a year, and a hospital can estimate how many patients will acquire an infection and how many of those will die. Other risks are harder to foresee – an example of this would be the risk to an airline company of a volcanic eruption which would disrupt air traffic; in 2010 the Eyjafjallajökull volcano in Iceland erupted, and led to huge losses and disruption for airlines in Europe. A risk such as this could easily have been dismissed either because it was considered too unlikely to take seriously, or because the scale of the effect may have been underestimated.

Conventional risk management procedures tend to focus on identifying, assessing and dealing with the risks associated with individual factors in a serial or linear fashion, and each factor is considered in isolation. But dealing with risk in this way is problematic: almost every risk arises from a combination of factors. An analogy is waves washing up on a beach – every so often one is much bigger than the others, while on other occasions waves will combine and reinforce each other to create one of much greater magnitude.

So while a risk register can be created and monitored, the danger is that it can give a spurious accuracy, and the impression that the risks are under control. It seems that most of the boards of banks which failed or suffered large write-downs believed their companies had good risk management. Unfortunately, it also seems that a recurring failing in the run-up to the banking crisis was the inability of many institutions to appreciate that the nature of the risks they faced was changing as economic conditions changed.

Conventional risk management also considers each risk in terms of its impact and the likelihood of the event happening. It would be better to consider risk in terms of cause as well as effect, and to take the trouble to consider the root cause(s) of risks related to specific factors.

For example, an accidental oil or chemical spill might create pollution. The spill could have many possible causes; it might be simple human error, or be a result of not having the right equipment to prevent it. The apparently simple human error could be a result of someone not taking care, or being overworked, or not being trained. Not having the right equipment might be the result of someone not knowing what equipment was available, or a reluctance to spend money on a new component, or lack of maintenance. Apart from natural events such as volcanoes, most risks can have many causes which can be related in a complex pattern. A doctor knows it is better to treat causes than symptoms. It is the same with risks. A careful analysis of the root causes of business failures shows that in many cases the underlying cause was cultural. It is therefore important for companies to take care to ensure they have the right sort of culture.

Current risk management tends to focus on risk factors which, while they may be significant to an individual business, are not big enough to threaten its very existence. In any analysis of the risks that bring organisations down, or come close to it, the root cause is usually identified as something to do with corporate culture.

4. Has risk risen up the corporate agenda?

In the UK, the Walker Review¹ of corporate governance of banks and other financial institutions correctly identified that the wrong types of behaviour were at the root of governance failure in many banks. During the course of the roundtable meeting of risk and governance experts which contributed to the preparation of this paper, one participant said that ‘we are now in hair-shirt mode’ – meaning that financial institutions accept that more frugal corporate behaviour is now expected.

This response, however, is far from being universal and may not amount to a permanent change. Already we have seen the extravagant behaviour of some of the bailed-out banks in awarding huge bonuses to their star traders, suggesting that they do not acknowledge the likely reaction of the public, governments and regulators. A recent survey of global businesses by the law firm Norton Rose² revealed that while three-quarters of respondents reported ‘increased prominence for risk management in their companies...[it] has not always been backed up by more money or staff.’ Of these respondents, 37% said that no extra resources had been allocated to the risk function.

That report added that while some respondents reported increased conservatism and ‘the revenge of the risk guys’, others said changes were being driven by regulators rather than emerging from within the institution, and expected that things would eventually return to normal. One respondent said of the rise of the risk management function: ‘The feeling is that this is temporary and once the good times roll, risk will be put back in its box.’

The report also revealed that only 19% of companies had considered an independent evaluation of their ethics, while 45% had no idea whether their company was considering doing so, which suggests that the idea has not gained wide currency.

A Deloitte study, to be published in June 2010, suggests that companies with only skin-deep commitment to risk governance and controls (RGC) are not helping themselves. Deloitte found a correlation between those financial institutions exhibiting best RGC practices and their financial performance (stock returns, ROE, and ROA over seven years: January 2003–December 2009). There was a

significant uplift in financial performance (23%) experienced by those with leading RGC practices compared with the lowest performers in the sample. This suggests that better RGC practices create the opportunity for higher potential financial returns for financial institutions.

Nonetheless the study also showed that, while progress has been made among financial institutions in terms of considering risk, governance and controls issues, compared with a similar survey carried out before the crisis in 2007 – with some notable ‘top performers’ in this field – most firms are still not exhibiting best practice. Deloitte found ‘patchy execution of policies and procedures, which means that controls can fail to be embedded into business units. This can cause a disconnect between the risk governance engine and the business.’

Deloitte concluded that:

the challenge is to elevate RGC to a more strategic level to ensure a deeper and lasting impact for the business, [and] at the same time improve the embedding of better behaviours in the day-to-day business practices. The agenda for change should focus on key areas such as compensation and monitoring of performance.

A KPMG global fraud survey for 2009³ also revealed rising levels of fraud cases around the world. The factors cited as contributing to fraudulent behaviour included: poor leadership by senior management; poor communication of organisational codes of ethics; lack of management commitment; and poor ethical culture. While it is a matter of some debate whether economic downturns actually produce more financial crime or simply uncover it, KPMG concludes that a strong culture of business ethics can help to prevent fraud.

What can be done? In the UK, the City regulator, the Financial Services Authority (FSA) has been taking a much more proactive approach and has intensified its practice of interviewing senior officials before they take up their posts. It has pledged to explore further how to ensure that corporate financial institutions adopt ethical frameworks and cultures. Reliable ways of assessing the cultural health of companies, or the risks posed by lack of it, have yet to be developed. It is important that regulated companies continue to take responsibility for appointments and for their own culture, and do not rely on regulators to do this for them.

1. Walker Review of Corporate Governance of the UK Banking Industry, HM Treasury, 26 November 2009.

2. Financial Institutions in the Future: Global Financial Recovery, Norton Rose, March 2010.

3. KPMG Fraud Survey, 2009.

5. Managing reputational risk

The surveys mentioned above do at least show growing awareness of the need for good ethics in business. This point is underlined by the generally hostile reaction in the US and elsewhere to the revelations which emerged in 2010 about the conduct of major US financial institutions. However, the cases of Lehman Brothers and Goldman Sachs are different in nature. Lehman's questionable 'repo 105'⁴ transactions, which kept £50bn off the balance sheet to improve the firm's debt ratios, involved an apparently deliberate attempt to evade regulatory standards. The allegations made by the SEC against Goldman Sachs⁵ on the other hand, suggest the development and retention of a business model that systematically failed to prevent large-scale conflicts of interest. Both cases, though, demonstrate that acting on the right side of the law is not in itself sufficient to be regarded as behaving ethically.

Companies face significant reputational risks if customers and other stakeholders do not like what they see or hear. These cases show that unpalatable facts cannot, ultimately, be hidden from external scrutiny. It can be argued that sunlight is the best disinfectant, and for this reason an open culture where issues of concern can be raised and resolved is fundamental to a healthy organisation.

While the types of risk which most exercise the minds of some executives may be those which can affect their remuneration, job tenure or liberty, reputational risk is probably the most important to the company. The demise of Arthur Andersen after the Enron, WorldCom and other scandals demonstrated how quickly a solvent and otherwise seemingly viable business can collapse. However, the cause of the reputational failure was errant behaviour (people risk), which was influenced not only by incentives (remuneration risk) but also by a belief that aggressive compliance with the letter of financial reporting and compliance standards while flouting their spirit was acceptable. Complacency was almost certainly another factor.

Large companies employ many people whose job it is to carry out orders from the board and feed information up to it through the corporate hierarchy. What senior manager would want to submit a report that raises awkward

questions, or which might challenge the executive directors? It is hardly surprising that boards will often be fed sanitised information, something which would encourage complacency. An investment manager at ACCA's UK roundtable said that, in his experience, some boards do fall into this category, and it is essential that directors get out and 'walk the floor' to find out what is going on. They, or at least the non-executive directors (NEDs), also need to ensure they have a capable, reliable and objective assurance function that feeds them timely, relevant and balanced information – warts and all. He regarded the willingness of the NEDs to do this as a useful 'litmus test' to see what sort of management he was dealing with.

While a risk to reputation may be the one that brings an organisation down, the Andersen case shows that reputational risk was an effect rather than a cause. Northern Rock and Lehman also failed because people lost confidence in them, but behind that loss of reputation lay factors such as credit, market, liquidity and solvency risks, and errors in strategy and in operations. Additionally, there were a number of external events that also presented threats.

Many chief risk officers (CROs) are aware of these challenges, and rightly consider that the most important thing is culture and its related risks and influences. Forward-thinking CROs try to influence the culture for the benefit of the company. ACCA would say that the chief financial officer (CFO) is the member of the board best placed to influence the culture positively, through setting the right example and having the training to inculcate a proper risk and ethics framework.

It would be foolish, however, to underestimate how hard this can be in some organisations, particularly those with a strongly hierarchal, results-orientated and closed culture. In a light-hearted but powerful way the *Credit Crunch Diaries*,⁶ the fictional blogs of the chief executive and the compliance officer of an imaginary failed bank, reveal how a corporate culture can render the compliance and risk management functions totally impotent.

4. Anton R. Valukas, *Proceedings Examiner's Report, Lehman Brothers Holdings Inc*, Chapter 11, <http://lehmanreport.jenner.com>, 2010.

5. 'SEC Charges Goldman Sachs With Fraud in Structuring and Marketing of CDO Tied to Subprime Mortgages', 16 April 2010.

6. David Lascelles and Nick Carn, *The Credit Crunch Diaries - The Financial Crisis by Those Who Made it Happen*, CSFI, 2009.

6. How should companies weigh risk against reward?

As we have seen, bailed-out banks have been accused of repeating the same reckless behaviour that got them into trouble. In its 2009 paper on regulation, ACCA argued that this behaviour arises from a lack of effective competition, where the market forces in the normal sense of the term do not operate. Other industries, notably the motor industry, have also experienced government intervention which has skewed market forces and broken the link between risk management and profitability. Where market forces and competition are allowed to operate normally, reward is the pay-off for taking and managing risk effectively, while failure is the price to be paid for taking too much risk or not managing risks properly.

It follows that companies should want to weigh risk against reward. How should they do this? The previous section discussed some of the complexities of managing risk, and we will discuss later some of the elements of good risk management.

Should it be self evident that a risk is worth taking if the expectation (expected value [E]) of reward is greater than the expectation of loss? That is, where the gain multiplied by the probability of that gain is greater than the impact of a loss multiplied by the probability of that loss. The simple formula is:

$$E(\text{Gain}) > E(\text{Loss})$$

In practice, when taking a decision, there may be more than one gain and more than one loss, so we should want the sum of the expected values of gains to exceed the sum of expected values of losses:

$$\sum E(\text{Gain}) > \sum E(\text{Loss})$$

Curiously, while it should be obvious that risks and rewards should be considered together, this is not the case. In many organisations, risks are 'managed' with little consideration of gain, and decisions are taken with scant regard to the risk. Sometimes, major decisions – such as to enter new markets or make an acquisition – are taken on a basis of gut feel, or driven by what Keynes called animal spirits, rather than after a cool weighing up of the risks against the rewards.

There are many reasons for this.

First, people are prone to a number of cognitive biases which affect their ability to assess risk. For example:

- Availability: people respond more strongly to risks when the consequences of those risks are available to them, such as from memory, from imagination, and from mass media. For example, if they witness a news item about a house fire, they are more likely to avoid the kind of behaviour that they believe started the fire.
- Anchoring: people's estimate of risk will tend to reflect any example they are given as a starting point. So, if they are asked to estimate various risks in everyday life, and are given an estimate of 1 in 20,000 of death in a road accident, their estimates of risks of death in accidents in the home will be relatively close to this, and will be higher than if they are given as a starting point an estimate of 1 in 200,000 of death in a rail accident.
- Optimism: individuals tend to see particular risks as less likely to apply to themselves, particularly if the activity is voluntary. For example, smokers perceive health risks from smoking in general, but see themselves as less likely to suffer from those effects.
- Hindsight: most people believe that their capacity to perceive and manage a previously encountered risk is greater than in fact it was.
- Confirmation bias: where people tend to reinforce their own beliefs, for example by deciding that a certain data point is 'an outlier' (an observation that is numerically distant from the rest of the data).

All this can mean that people either think they understand the risks, or do not want the bother of carefully weighing the risks against the rewards.

Secondly, there is the well-established phenomenon of ‘group think’. Groups of people are prone to biases which tend to lead to a greater acceptance of risk if group members can hide behind a diffused responsibility; alternatively it can lead to over-cautiousness. One can see this happening in a board meeting. A group can embark upon something – or fail to challenge something – that a member of that group would not choose to do on his or her own. It begins to explain why NEDs have not always provided the necessary challenge; RBS’s disastrous acquisition of ABN Amro might be considered an example here. The example might easily be extended to the behaviour of shareholders when invited to support the recommendations of directors.

A full account of these biases is provided in the Lloyds report, *Behaviour: Bear, Bull or Lemming?*⁷

Risk management in many organisations has evolved either from the approach used by insurance specialists, who manage predictable and frequent risks, or from internal audit functions. Internal auditors tend to take more of a systems approach to risk. But neither group, culturally speaking, is used to balancing risk with reward. In fact the people considering risk are often, if not usually, different from the people whose job it is to make money. Once again this tends to mean that risks are considered individually and in isolation.

The Walker Review contains numerous mentions of risk appetite and risk tolerance, and considers an understanding of them to be intrinsic to effective risk management. Unfortunately, this is another highly problematic area.

Risk appetite and risk tolerance have become very familiar words but their meanings are not always clear. A survey of risk specialists’ views on risk terminology, conducted by ACCA and Matthew Leitch,⁸ found there are no generally agreed definitions of risk appetite or risk tolerance and much confusion about what the terms mean in practice. One respondent said that risk appetite is such a nebulous concept that he had never heard it clearly defined, and he had no idea what it means or how one would set its parameters.

Although there are issues with defining these terms properly, it must be beneficial for a company to consider its attitude to risk and what sort of risk it is prepared to take, with reference to the reward or gain envisaged:

E(Gain) > E(Loss).

The new UK Corporate Governance Code⁹ recognises this by including the following in its main principle on risk management and internal control.

The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives.

It will be interesting to see how boards report how they have done this.

7. *Behaviour: Bear, Bull or Lemming?* (Lloyds Emerging Risks Report), Lloyd’s Emerging Risks Team, 2010. <http://www.lloyds.com>

8. ‘Results of a Survey of Alternative Risk Phrases’ [online text], <http://www.internalcontrolsdesign.co.uk/raphrasequizresults>

9. *The UK Corporate Governance Code*, Financial Reporting Council, 2010. <http://www.frc.org.uk/corporate/ukcgcode.cfm>

Risk management is sometimes seen as a hindrance rather than a help to business success. Sometimes this will be because risk management is not practised properly.

In one ACCA member's experience, a company's management is often wary at the outset and sceptical of the value of risk planning. But after putting in risk management programmes they see the point of it and how it helps. There is initial resistance but they are won over (see Box 1).

Box 1: Dealing with risk: a case study

It took a newly appointed CFO of an FSA-regulated listed company several months to get the executive board to accept the merits and relevance of a risk-management framework. This task was made easier as she could continue to pursue this matter with her fellow directors inside the organisation. However, the difficulty lay in the perceptions of board members that risk represented negativity, was a bureaucratic tool, had no real added value, and disrupted both business development and the decision-making process. Being a trading organisation, it had only a very narrow understanding of risk, which was that either the firm would make, or would not make, profit the following day.

The trigger for a change in perception came when the company was developing a clear business strategy. The CFO seized the opportunity to properly discuss business risks in the wider context (regulatory, financial and operational risks), and how these might affect delivering the strategy. Only then did the executive board understand and accept that risk management was a tool that would potentially enable them to deliver business success in a controlled manner.

Since the risk policy and framework were adopted, discussions on risk feature regularly at board meetings. Key decisions now highlight risks and their impact on strategy! The FSA also requires financial services firms to produce a report on the Basel Committee's ICAAP (Internal Capital Adequacy Assessment Process) rules, which necessarily requires highlighting key risks that might interfere with capital adequacy requirements.

In conclusion, it is sometimes necessary to persevere in order to persuade senior management to embrace risk management. It can take time and effort to change perceptions, but the recent economic turmoil and countless debates on risk in the banking sector should hopefully ease the task of establishing a risk culture across the organisation.

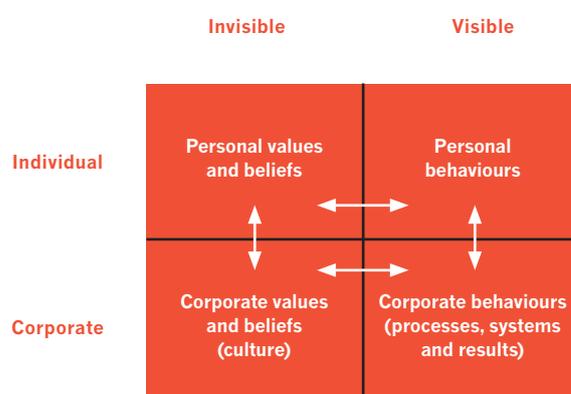
7. Corporate vs individual risk

While it is hoped that directors and staff will consider risk and reward objectively in the interests of the company, human nature means that people may be tempted to place more emphasis on their own personal reward and risk. The scandals of 2001 and 2002, as exemplified by Enron and WorldCom, and more recent examples¹⁰ of traders able to bet their institutions for personal gain, provide ample evidence of the basic behavioural problem of human beings having an excessive faith in their own abilities and judgment.

Just as companies will take risks for reward, so will employees. The difficulties of how to align executives' pay with their performance are well documented, though it should be stated that incentive pay is a good principle, as long as the long-term benefits of the company are the key criteria, not merely short-term gain. The challenge is to ensure that incentive pay gives incentives to the right behaviour.

Beyond the issue of pay and incentives, it is also important that companies appreciate what drives behaviour. Figure 1 illustrates that, as individuals and as companies, we have beliefs and values. These are not visible to anyone, but what is visible is our behaviour – what we do. Our behaviour is driven by our beliefs and values. Corporate policies and procedures focus on what is visible, particularly the lower right quadrant. Arguably, companies should focus more on the lower left quadrant of corporate beliefs and values and the extent to which they are congruent with the personal values of the people in the organisation. An example of how this could be done is given in section 16, 'How do we know if we are being ethical in business?'

Figure 1: Linking individual and corporate values and behaviours



10. See for example, *Shareholder Report on UBS's Write-Downs*, UBS, 2008.

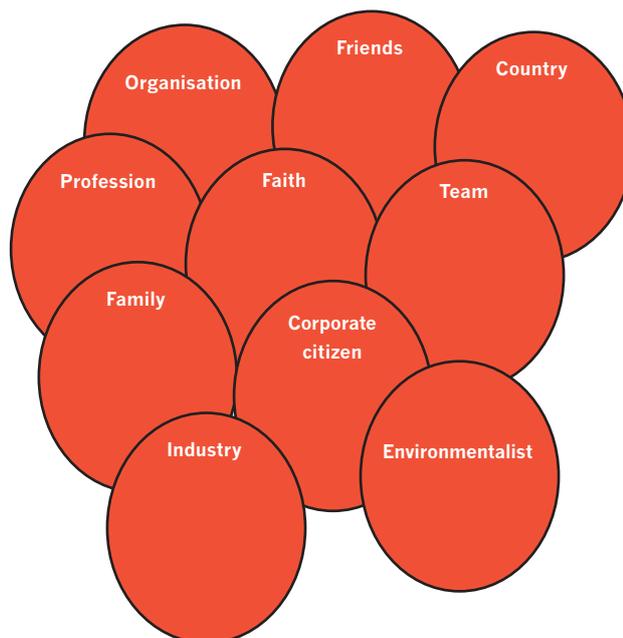
8. What do we mean by 'business ethics'?

The Institute of Business Ethics (IBE) defines business ethics as the application of ethical values – such as integrity, fairness, respect and openness – to business behaviour. Another useful definition is 'principles or norms of behaviour regarded as desirable by the most of society'.¹¹ Society, however, is not homogeneous: it comprises many communities, which means that a view of what is ethical will differ from one community to another. Even in one town in one country there will be many different communities: rich and poor, highly or not so highly educated, religious and so on. Similarly, a company may have a corporate culture but within that will be many sub-cultures or communities, and those working in a company will feel an allegiance to particular communities, and will possibly feel antipathy to others when making a business decision. When you make a business decision, would all the communities in the company approve, or would some be adversely affected?

When a company tries to ensure that its employees act ethically, it is likely to begin with a code of ethics or conduct. Such codes tend to lie on a continuum, where at one end they are rules and compliance-based and at the other end they are values or principles-based. The former tend to consist of dos and don'ts while the latter are aspirational. Most codes are a mixture of these.

In practice, ethical considerations will involve legal requirements, such as criminal, contractual and civil provisions; indisputable obligations such as the observance of various accepted, non-legal, human and anti-discrimination rights; formal protocols such as rules and policies which may include putting indisputables and other matters within a company framework. Beyond this, we have the behaviour which might be expected by society, and which may or not be covered in company CSR policies.

Figure 2: Ethics in different communities



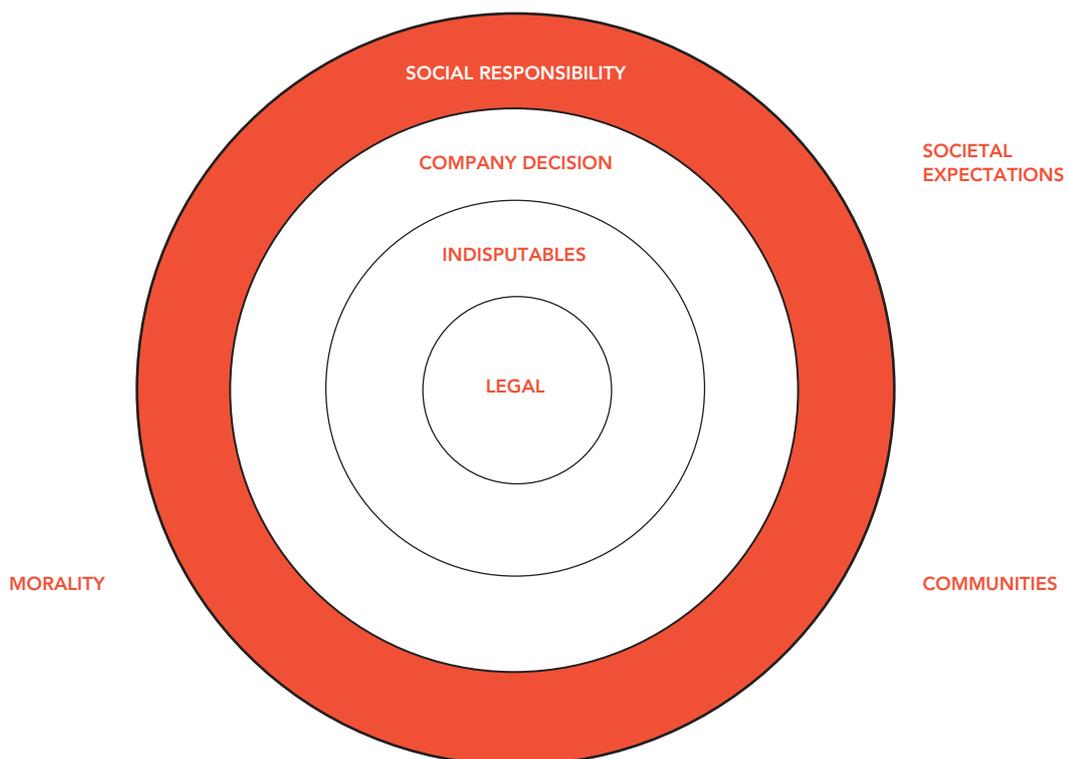
11. Articulated by Paul McKosz, PDK Control Consulting, Canada.

Outside these circles, we have a rather nebulous area but which can easily be summed up in the phrase ‘doing the right thing’ – and this is where business ethics really come in. Knowing what the right thing is will often be straightforward and unproblematic in our personal lives, but the dynamics of the business environment – the duty of loyalty owed by directors and employees to their company, the onus on us to achieve our targets, the competitive environment in which individuals and businesses all operate – make it more difficult. Knowing what the right thing is can also appear easier with hindsight after one has knowingly or unwittingly crossed an invisible line of transgression. The term ‘moral compass’ is sometimes used, to refer to the means by which people are guided in knowing and doing the right thing.

Codes of ethics for the most part describe the behaviour required in particular circumstances. The better codes are rooted in a set of values. But organisations do not have values – only the individuals within them do. Therefore, codes tend to reflect a consensus of the values that certain people think they should have, or would like to believe they have.

It is worth observing here that written codes of ethics, or any rules or procedures, will be interpreted in different ways. In some countries and cultures it is important to ensure that a company’s ethical requirements are compatible with the prevailing religious requirements. It is well known that culture will trump compliance. Whether company rules are followed, bent or ignored will depend on the corporate culture or team sub-culture. Boards and management should ensure they understand the culture in their companies. Unfortunately, reliable tools to do this are only in the early stages of development.

Figure 3: Circles of expectation



It follows that boards will want to ensure that their employees observe the ethical requirements of their rules, policies and codes. It is harder for boards to set requirements about morality, but they should consider that transgressions of morality tend to be seen, at least by the media, as being perpetrated at the executive level. Enron is the classic example here. Non-executive members of the board would be well advised to pay attention both to their own and their executives' moral compasses.

Boards can help to ensure a working moral compass by stating the desired corporate values clearly, then demonstrating clearly – by word, incentive and performance management systems and, most importantly by personal example – that boards are serious about them.

It is sometimes said that we have a case-based understanding of ethics. Ethics can be difficult to consider in abstract terms; it is much easier to think of ethics and morality by referring to examples. This is consistent with the approach taken in the ACCA qualification (explained later in this paper). Rather than train people in ethics, the most effective way to help a company make sure it has a working moral compass is probably for it to encourage people, at all levels, to consider decisions from an ethical perspective, and to discuss in groups both hypothetical and real ethical dilemmas. Companies that have done this have found that the effect on the ethical health of the company is like an inoculation against a virus. Executives and staff become more aware of, and sensitised to, ethical considerations, so unethical behaviour is more likely to be weeded out.

Finally, we should note that there can be competing business, compliance, ethical and moral requirements. At the time of writing, banks are being told to adhere to greater capital requirements – but are also being pressurised to lend more. So there seem to be ethical pressures in conflicting directions.

It has been argued that the current financial problems have exploded previous certainties – which set of rules should businesses follow? Is being ethical more important or is trying to do what's necessary to save your company in a harsh economic environment? Compliance is one of many expectations which cannot be reconciled. There needs to be a hierarchy of priorities, in which, for example, safety trumps profit.

It has been put to us that, in some areas of business, ethics have not always been taken seriously, and lip-service only has been paid to them. This situation seems to have changed somewhat, but what will ensure that such change is permanent? Is the solution to find a way to allow people's 'better nature' to come to the fore in the business context, or is it to resort to stronger enforcement on the part of regulators? And when companies comply with ethical rules or codes for fear of being jailed, does this really count as ethical behaviour, or is it just self-preservation? Does it even matter as long as the behaviour is good?

Ultimately, if ethics in business are not to be disregarded, it must make business sense. The comments we have received, suggesting business people believe there is a link between ethics and good performance, are greatly encouraging. Kenneth Henry FCCA, Professor of Accounting at Florida International University, told us: 'An entrepreneur has to choose whether to buy into it – he has to believe it is good for his business in the long term.'

9. Is regulation sufficient to encourage businesses to manage risk responsibly?

The amount of legislation, regulatory rules, codes of practice and the like has never been greater. Compliance costs for the largest companies are immense, both in financial and time terms; the accumulated weight of these compliance burdens adds substantially to the cost of doing business, and means that companies must strive to earn ever greater revenues in order to cover their costs. The regulatory machinery needed to operate these controls is correspondingly great. With each successive financial scandal and human tragedy there are invariably calls for new controls on business to be brought in – this has certainly happened in the wake of the 2007 global banking crisis. But the way to reduce the fall-out from corporate failures cannot simply be to increase the number of legal and regulatory rules that are imposed on businesses. In the case of the banking sector, it often tends to be forgotten that regulatory rules leading up to the crisis were extensive and very prescriptive, suggesting that the various banking failures occurred, not because of a lack of regulatory controls, but despite them.¹² Likewise, major corporate failures have occurred despite accounting rules and corporate governance guidance being followed to the letter by the companies concerned. It seems inevitable that, irrespective of what governments and regulators do to tighten and expand regulatory controls, scandals will continue to occur, and the controls will continue to fail to stop businesses from engaging in conduct which might be described as irresponsible.

How can this be? There seem to be four likely explanations:

- There is a failure to frame regulatory controls in the way which is most likely to achieve the regulatory objectives. The virtue of imposing detailed and prescriptive rules is that both sides, the business and the regulator, should know exactly what is being demanded, and compliance can proceed accordingly. The disadvantage of an excessively rules-based approach is that it encourages a search for loop-holes, and can entitle a business to think that by complying with the precise terms of an instruction it can feel justified in acting in ways which would otherwise be regarded as unacceptable. While a more principles-based approach focuses attention on desirable outcomes rather than procedural detail, businesses and regulators alike may feel that both their jobs are made easier if there is more certainty about what is expected of them.
- The obligation to comply with regulations is seen by the regulated parties only as a bureaucratic burden, having no fundamental relevance to their operations. The risk here is that the entities concerned may respond in a mechanical fashion which aims to meet the precise standards expected of them and no more. This situation will always create the potential for regulated parties to observe the letter of requirements but not the spirit (where such a spirit can be said to exist).
- There is a lack of proper supervision and enforcement of regulatory rules/principles. If any set of compliance rules or principles is to be credible as a tool for driving business behaviour, there needs to be some effective means of assessing compliance with them and, where appropriate, of taking remedial action against those who are non-compliant. It could be argued that the bigger and more complex a business becomes, the more difficult it will become for any official organ to effectively regulate it.
- There is a failure on the part of businesses to show genuine commitment, not only to complying with the objectives behind external compliance obligations, whether they are laws, rules or principles, but also to the fundamental virtue of acting in a way which, at the individual human level, they must know is 'right'. The experience of many recent high-profile corporate scandals – from Maxwell to Enron and WorldCom to the 2007 banking crisis – suggests that, while governments and regulators may periodically reform their laws and technical rulebooks, the deeper problem lies elsewhere. It lies in the failure, conscious or otherwise, of some in the corporate world to see ethical business behaviour as being in the interests of their company, and sharp practice as posing a material risk to those interests.

Laws and regulations, and the effective enforcement of them, can certainly help business to pursue a responsible alignment of risk with reward. For example, standardisation of accounting rules is highly desirable, so that all investors and other interested parties are able to use information prepared on a uniform basis. The expanded legal approach to the purpose of the limited company, as outlined above, does help to encourage companies to acknowledge that thinking about long-term consequences, and a wider range of stakeholder interests, is likely to improve the quality of board-level decision making. And

12. *The Future of Financial Regulation*, ACCA, 2009.

legislation to criminalise bribery and corruption also injects a strong moral dimension into the environment in which business operates. The effective enforcement of legal and regulatory measures also acts as a very powerful tool of deterrence and persuasion (witness the recent series of successful prosecutions against the German company Siemens), and serves to demonstrate forcibly to companies the business risk associated with engaging in unethical and illegal practices. Only the law, moreover, can effectively intervene to set categorical boundaries for the conduct of certain types of business.

But, as noted above, external regulation can only hope to achieve so much by obliging companies to comply with technical laws, rules or principles. If businesses cannot see the relevance or advantages of the regulation of their operations, they are likely to respond in a 'tick-box' manner. As also noted above, rules which invite manipulation may also, effectively, legitimise underhand and damaging practices. And it must be acknowledged that regulatory bodies in all countries will always be subject to resource limitations which will constrain their ability to supervise everything that is done in the sector concerned.

Ultimately, the actions of companies are the actions of their people. In some cases, directors will knowingly allow their companies to engage in activities which are either plainly illegal or (arguably) unethical. At other times such actions will be committed by executives below board level without the directors being aware of what is going on. Alternatively, illegal or unethical conduct may be practised by individual members of the workforce independently, and in breach of company rules or codes of conduct. However such conduct happens, the company will invariably be held responsible for the actions of its people, and will risk suffering criminal and reputational consequences when it does. Even if a company does not appreciate the inherent virtue of avoiding illegal and unethical courses of conduct, it must surely understand the business risk of incurring such repercussions.

So while the directors, shareholders and employees of any commercial company will always have an understandable interest in trying to enhance its profitability, companies must at the same time recognise the self-interest, as well

perhaps as the wider social interest, of acting in accordance with high standards of business conduct. In particular it must be seen to be in the interests of companies and their various stakeholders that all those who work for a company share a commitment to conducting business honestly and in a way which aims to reduce the level of risk to the company and those stakeholders. Along with the need for companies to have personnel with the right abilities and experience, this approach must represent the best chance of achieving the effective regulation of business.

A commitment to ethical business conduct can be encouraged by external regulation, and in this context it is welcome that fitness and propriety checks are now being undertaken, in the UK and elsewhere, on new directors and senior executives in the finance sector, in the wake of the post-2007 banking scandals. Ultimately though, the commitment must come from within the individual company. This has to involve the recognition that senior figures in a company, in particular CEOs and CFOs, should be required to have personal qualities that are conducive to ethical business conduct. There needs also to be a serious effort on the part of companies to install an ethical culture: this should be sufficiently robust to ensure that unacceptable practices are identified and managed appropriately, and sufficiently credible to allow individuals who have legitimate concerns about business practices to channel those concerns within the company without fear of adverse consequences.

An ethical culture should involve the application of ethical considerations to all aspects of its operations, including objective setting, its policy on remuneration and incentives, financial reporting and personnel management. In the case of larger companies at least, an integral part of their ethical business culture must be an acceptance of the need to be transparent about corporate strategies and working practices, and a preparedness to reconcile them with known and anticipated stakeholder reactions. Within this sort of culture there should also be a genuine commitment to encouraging the responsible use of whistle-blowing procedures, which must involve safeguards to ensure that people who do make use of such procedures do not suffer as a result.

10. Can ethical standards be imposed from above?

It is not reasonable to expect businesses to act altruistically. The rationale of any commercial business is invariably to make money and to make profits. Each business sets about doing this in a competitive environment in which it and its competitors all seek to win business by offering attractive goods and services at prices that they think will appeal to consumers. Becoming more successful than your competitors, and driving them out of business as a result, may be detrimental to the interests of those other firms and their stakeholders, but as long as business is conducted legally and in line with principles of fair competition failure is a normal feature of the free market.

A business that voluntarily forgoes economic opportunities will not only jeopardise its own existence but may well harm the interests of its shareholders, and invite legal action from them for doing so. Thus, when we talk about businesses behaving ethically, we must acknowledge that their situation is quite different from that of the individual, who enjoys much greater freedom to make choices: expectations of ethical conduct in the business world must acknowledge at the outset that each business operates in a competitive market and is motivated by the legitimate pursuit of business and profit. The special challenge in the highly competitive world of business is how to encourage each party to conduct its operations in a way which ensures that the pursuit of its own short-term self-interest does not unfairly infringe upon the interests of either their competitors or their own stakeholders.

Acknowledging the special character of the business world is sometimes a problem for governments and regulators when they try, for understandable reasons, to impose politically motivated norms upon it. Arguably the best example of this comes from the United States in the 1990s, referred to earlier in this paper, when the then-government sought to increase home ownership among certain sections of the community. This intervention was arguably a significant contributory factor (albeit only one) in the sub-prime crisis which broke some years later. During the Clinton administration, the Community Re-Investment Act (CRA) of 1977, which had been passed to outlaw discrimination by banks against low-income households, was reinforced with a view to exerting more pressures on the banks to lend to sections of society not

previously associated with home ownership. With the same end in mind, the administration reduced the capital requirements of Fannie Mae and Freddie Mac, and instructed them to provide more credit to those who would normally be regarded as being poor credit risks. Loans to the sub-prime market in the US increased from 2.4% of total mortgage loans in 2000 to 13.7% in 2006. The huge increase in the demand for credit, for which these initiatives were partly responsible, led the banks to borrow heavily from abroad, creating the substantial macro-economic imbalances that we saw by the mid-2000s; the additional risk that they took on by lending to the sub-prime market prompted their ill-fated involvement in the securitisation market.

The reform of the CRA may have been motivated by legitimate egalitarian aims which the elected government of the day was entitled to pursue. But, in retrospect at least, it cannot be said that it was helpful to the banks in terms of encouraging them to operate effective risk management practices. And neither can it be said that it was helpful in ethical terms, since the political aims of the government were not effectively integrated with the business objectives of the financial institutions affected. The financial sector was asked to incorporate into its business plans quasi-ethical factors which were inconsistent with responsible commercial practice in that sector, and the eventual result was to the enormous detriment of the banks, and had disastrous results for their affected customers.

A far less dramatic example of the issues involved in trying to 'square the circle' is the UK Companies Act 2006, referred to above, in which the interests of all stakeholders have to be borne in mind by directors. However, the interests of shareholders who want higher dividends if they are to invest in the company will inevitably clash with those of employees who want higher wages. Some of the respondents ACCA spoke to in the preparation of this paper argue that this has complicated the UK's business arena in an already tough economic climate.

The US example suggests that the imposition on business of ethical or quasi-ethical principles from above may not only be unhelpful but dangerously counter-productive. Ethical policies and practices need to be appropriate to

the environment in which the business operates, which means that government and regulators are not necessarily the right source of ethical guidance. It should also be borne in mind that ideas about what constitutes responsible business conduct may vary between different business sectors and different markets. Professional bodies, for example, are well placed to identify the ethical standards which are to be adopted by members of the profession concerned, because of their knowledge of the circumstances in which those individuals operate, and the specific pressures which threaten the integrity of their actions. While it may be fair to argue that certain fundamental principles should be able to be applied to all sectors and markets, it must also be accepted that norms of acceptable business practice and custom may vary: this will often be the case from country to country, and also where the ethical principles followed by a business or community are based on fundamental religious principles.

While it is perfectly reasonable, therefore, for the law and regulation to expect businesses to behave in a responsible and ethical way (for the reasons already discussed), it is not realistic to expect ethical principles to be framed in a uniform way, or expect them to be applied in the same way in all circumstances.

11. Rules and principles, and how to enforce them

The 2007 financial crisis involved a catalogue of unintended consequences of regulation of one form or another. Prior to 2002, a culture of conforming to the letter and not the spirit of accounting requirements meant that Enron could use accounting tricks to hide liabilities off its balance sheet and book profits which could never be realised. Even after the Enron scandal, banks were still able to use a variety of accounting devices to move assets and liabilities into special purpose vehicles (SPVs) which were not consolidated on their group balance sheets. And, as has been alleged, Lehman made assets and liabilities effectively disappear from its balance sheet by cherry-picking the jurisdiction in which to obtain its legal opinions, and in which to select its accounting or reporting standards.

These problems arose in the US. However, a paper published by ACCA 'The Accounting Statements of Global Financial Institutions and the Recent Crisis'¹³ describes some of the other unintended consequences of financial reporting requirements which applied to both US and European banks. Many commentators in those markets are now arguing that financial reporting and auditing requirements have become too rules-based and have not left enough room for judgment.

ACCA supports principles-based systems, which work well in a principled environment. But in businesses where the culture is to comply with the letter and not the spirit of the rules, such a regime can appear to lack teeth.

We see this with corporate governance requirements. In the UK, the corporate governance regime for listed companies consists of a code of principles and provisions. The Listing Rules require companies to state in their annual reports how they apply these principles, and to state whether they comply with the more rule-like provisions or explain why they do not. Unfortunately, attention by shareholders and others has always focused more on compliance with the provisions than on how companies apply the principles. Not surprisingly, few companies bother to give meaningful descriptions of how they do apply the governance principles.

A simple example contrasting rules and principles is the 30mph driving speed limit. This is a rule: a principle might be 'always drive safely' and a supporting principle 'too much speed kills'. There should be fewer accidents if people follow the principles. Depending on road conditions, it may be safe either to drive faster than 30mph or dangerous to drive at that speed. A compliance mentality would be that it is OK to drive at 30mph even if conditions mean that such a speed is unsafe. On the other hand, in a culture where the drive safely principle is flouted, perhaps we need rules.

In the Netherlands, an approach called 'naked streets' has been tried. Dangerous junctions were stripped of traffic lights, road signs, directional markers and pedestrian crossings. To the approaching driver there was nothing to tell drivers what to do, so they had to think for themselves. As a result, drivers seemed to approach cautiously and with an eye on what others around were doing. Supporters of the 'naked streets' concept argued that drivers, pedestrians and cyclists were forced to interact, make eye contact and adapt to the traffic, instead of relying on signs and signals. They were given more responsibility for their actions on the road. Without the conventional rules of the road in place, drivers tended to slow down and develop an understanding of their environment. It may be that road users pay less attention to their surroundings if they feel protected by an array of signs telling them what to do. In the UK, local councils trying this approach also found that accidents went down as did average speeds but, paradoxically, traffic moved more efficiently and journey times decreased.¹⁴

13. B. Davies, G. Levine and A. Milne, *The Accounting Statements of Global Financial Institutions and the Recent Crisis*, ACCA, 2010.

14. *Risk, Responsibility and Regulation: Whose Risk is it Anyway?*, Better Regulation Commission, 2005.

ACCA was one of the first to point out,¹⁵ and it is now widely accepted, that the 2007 banking crisis was a corporate governance failure. As noted earlier, all the banks that failed had complied with corporate governance requirements. What they did not do was apply all the principles in their behaviour. The Walker Review identified that the problem was one of behaviour, but its solution is, essentially, to have more requirements with which to comply. It remains to be seen whether it will have the desired effect on the behaviour of companies. ACCA has long argued that greater emphasis should be placed on principles, and it is encouraging to see that the FRC's new *UK Corporate Governance Code* does this. We would have liked the new Code to have gone further and require companies to state how they apply, what has been a supporting principle, that boards should set the company's values and standards. We would also like companies to state how they ensure and monitor that these values and standards are in place.

Corporate governance is now in a hiatus. Many people now realise that, while in the 1990s it may have been practicable to expect institutional shareholders to enforce good governance, this is now much more difficult. In the UK, for example, their ownership of UK plc is considerably reduced. In 1992, pension funds and insurance companies held 53% of UK shares. By 2008, this dropped to 26% and the proportion of UK shares held by investors outside the UK increased from just 13% to 42%.¹⁶ (Incidentally, this reduction has been caused not only by shareholders holding more shares of companies based outside the UK but also, according to some managers of pension funds, to changes in accounting standards and actuarial practice, which they say has led to pension funds now holding a lower proportion of their investments in equities and a higher proportion in other assets such as bonds. The latter, if true, would be another unintended consequence of compliance.)

If shareholders will not enforce good governance then who will? Neither the FSA nor the FRC has ever disciplined a company for failing to apply a combined code principle. Should they?

The Basel Committee on Banking Supervision set out capital adequacy requirements intended to ensure that banks had adequate capital with which to withstand financial instability. Unfortunately, it was possible to circumvent these seemingly sensible requirements by moving assets into special purpose (also known as structured investment) vehicles (SPVs). The Basel requirements also encouraged all banks to operate very similar risk models. What this meant in practice was that when one bank wanted to buy a type of asset, they all did, and when one bank wanted to sell it, they all did. A market where there is effectively only one participant is not a market, so there should have been no surprise that bubbles were followed by crashes. This is well described by Avinash Persaud.¹⁷

The Basel requirements and US SEC requirements also meant that the opinions of the three main ratings agencies were essential to the banks' ability to carry out business, be it creating synthetic products or borrowing money. Such regulation stifled any potential for competition and contributed to their difficulties.

Another problem with regulation is its enforcement. Richard Scott Carnell, in *Regulator's Incentives*,¹⁸ describes the difficulties of the regulator's job in the US.

A bank can look healthy and report record profits even as it slides toward major losses. A regulator may attract considerable resistance if he takes early corrective and preventive action. Few people will think of the problems averted and a regulator may be criticised by bank trade associations, house builders, estate agents, the media and politicians for endangering jobs, housing markets, entrepreneurship, and the nation's prosperity.

15. A. Berendt and P. Moxey, *Corporate Governance and the Credit Crunch*, ACCA, 2008.

16. 'Share Ownership Survey 2008', *Office for National Statistics Bulletin*, 2010.

17. Avinash Persaud, 'Regulation, Valuation and Systemic Liquidity', *Financial Stability Review*, No. 12, October 2008.

18. Published in *Make Markets be Markets*, Roosevelt Institute, 2010.

Scott Carnell summed it up.

We have difficulty telling good banks from bad – until it's too late. We have difficulty telling good regulation from bad – until it's too late. Lax regulation wins more friends and plaudits than stringent regulation – until it's too late. Risky banks and their allies exert more political influence than taxpayers – until it's too late. These dynamics contribute to a stubborn reality underlying the regulatory failures of the past four decades: bank soundness regulation has no political constituency – until it's too late.

Compliance requirements can also hinder risk management. According to Bank Governance Leadership Network Update:¹⁹

dealing with regulatory matters 'crowds out' other critical risk activities. The growing list of vaguely defined and sometimes duplicative regulatory reporting requirements is a major drain on the time and resources of the risk function. At some banks, regulatory matters now take up 40% of the risk organization's time. At one organization, the CRO is currently completing 19 separate surveys in response to regulatory requests; another CRO has identified over 200 best practices that regulators are asking firms to benchmark themselves against. Some institutions are considering having all regulatory activities report up to the CRO. Given this focus on regulation (some organizations are requiring all people who handle regulation report to the CRO), in the future, 'CRO' may come to mean chief regulatory officer as well as chief risk officer. Risk executives point out that, ironically, 'in the end, this means we are spending less time looking for risks, analyzing risk, and helping to position the firm for success.'

Finally, we argue that 'compliance' is easier for human nature to deal with than applying judgment. It allows us to surrender responsibility for our own actions and saves us the trouble of wrestling with our conscience. The Lehman 'repo 105' story is a case in point. Its executives were concerned about risks to the bank and to their own security. They discovered that it was possible, through using an English legal opinion and US GAAP, to account for what was, in any commonsense interpretation, a financing arrangement of \$50bn as a sale, thus at a stroke removing that sum of assets and liabilities from the balance sheet.²⁰ While allowable in law and the relevant accounting standards, this must still be a deeply questionable course of action for an institution to take.

For a professional, however, it is not so simple. Accountants have a professional duty to comply with relevant financial reporting and auditing requirements and with the law. If a legal opinion says a financing transaction is a sale, and it is then possible under US GAAP to account for the \$50bn transaction as a sale, it would be difficult for a professional accountant to do otherwise. His/her conscience might say it is the wrong thing to do but in practice there will be little choice.

Accountants' professional duties are enshrined in the ethical standards set out by their professional bodies, which are based on the International Federation of Accountants (IFAC) Code of Ethics.²¹ These standards are predicated on the basis that financial reporting and auditing standards will give a sensible result. Under both UK reporting standards and IFRS there is an overall requirement that accounts show a true and fair view of, or (in the case of IFRS) present fairly, the affairs of the company. Both sets of standards allow for the possibility that compliance with the standards may result in a misleading picture, and if so then full details should be given. In the UK, this is known as the 'true and fair override'. It is rarely used, and it is not really clear whether, in practice, US GAAP has a similar requirement.

19. 'Bank Governance Leadership Network Update' [online text], <http://www.Tapestrynetworks.Com>, February 2010.

20. Anton R. Valukas, *Proceedings Examiner's Report*, Lehman Brothers Holdings Inc, Chapter 11, 2010.

21. *2010 Handbook of the Code of Ethics for Professional Accountants*, IFAC, 2010.

In its 'Introduction and Fundamental Principles' the IFAC Code sets out the public-interest duty of a professional accountant.

100.1 A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. Therefore, a professional accountant's responsibility is not exclusively to satisfy the needs of an individual client or employer. In acting in the public interest, a professional accountant shall observe and comply with this Code. If a professional accountant is prohibited from complying with certain parts of this Code by law or regulation, the professional accountant shall comply with all other parts of this Code.

The IFAC Code allows for the possibility that compliance with the Code could result in an outcome which is not in the public interest.

100.11 When a professional accountant encounters unusual circumstances in which the application of a specific requirement of the Code would result in a disproportionate outcome or an outcome that may not be in the public interest, it is recommended that the professional accountant consult with a member body or the relevant regulator.

This provision would appear to apply to the Lehman 'repo 105' situation. However, faced with the legal opinion and required treatment under US GAAP it would be unusual for any CFO to stand up and say that the action was wrong – particularly if such a course could threaten the future of the bank. What board is likely to consider the ethical niceties of an accounting transaction when both the law and the accounting requirements direct a particular course? What board would do this if the future of the company and everyone's job was on the line? Given these circumstances, it is easy to see how individuals would set aside any personal discomfort over not 'doing 'the right thing' and simply comply with the rules and standards.

In this context we accept that professional bodies and other organisations which exercise disciplinary functions have their own part to play in ensuring that individuals and firms who operate within their jurisdiction do not compromise the ethical and professional standards which are expected of them.

One respondent summed up the dilemma as 'getting it right when there is no right answer'. Perhaps the most important advice to give to accountants and other professionals in such situations would be always to consider the long-term impact on the business: 'Focus on the sustainability of profitability...or more importantly the very existence of the business, which would clearly not be possible if the business were to suffer a serious reputational risk on account of ignoring ethical considerations'.

12. Ethics as a facilitator or inhibitor of profit

Several surveys have suggested a correlation between ethical behaviour and profitability. For example, surveys by IBE in 2003 and 2007²² found that companies with ethical codes performed better on a variety of financial and other indicators than those without.

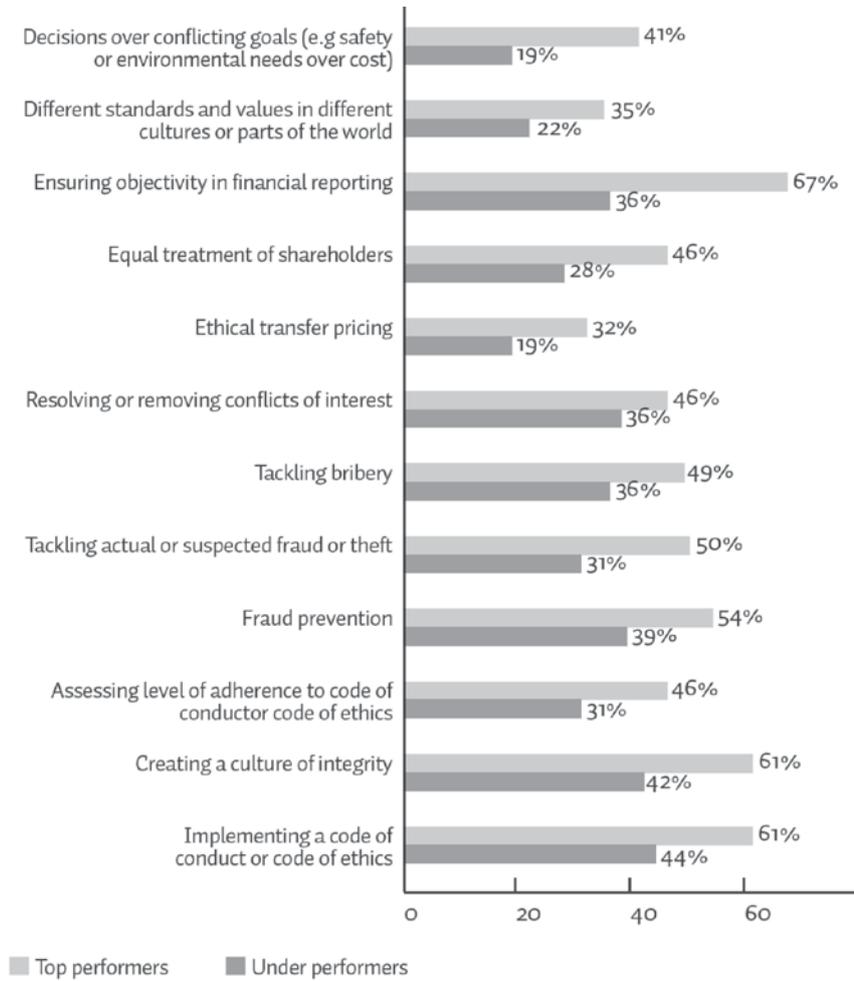
A survey carried out by CFO Research Services on behalf of ACCA in 2006,²³ of companies in Europe, Asia-Pacific and the US, found a correlation between companies having practices likely to result in ethical behaviour – such as training on ethics and including ethical performance in staff appraisals, and where boards had given attention to ethical matters – and financial performance rated (by themselves) as exceeding expectations. Individual descriptions from respondents of the key benefits of an ethical culture also strongly suggested a clear link between ethics and business performance (see Figure 4).

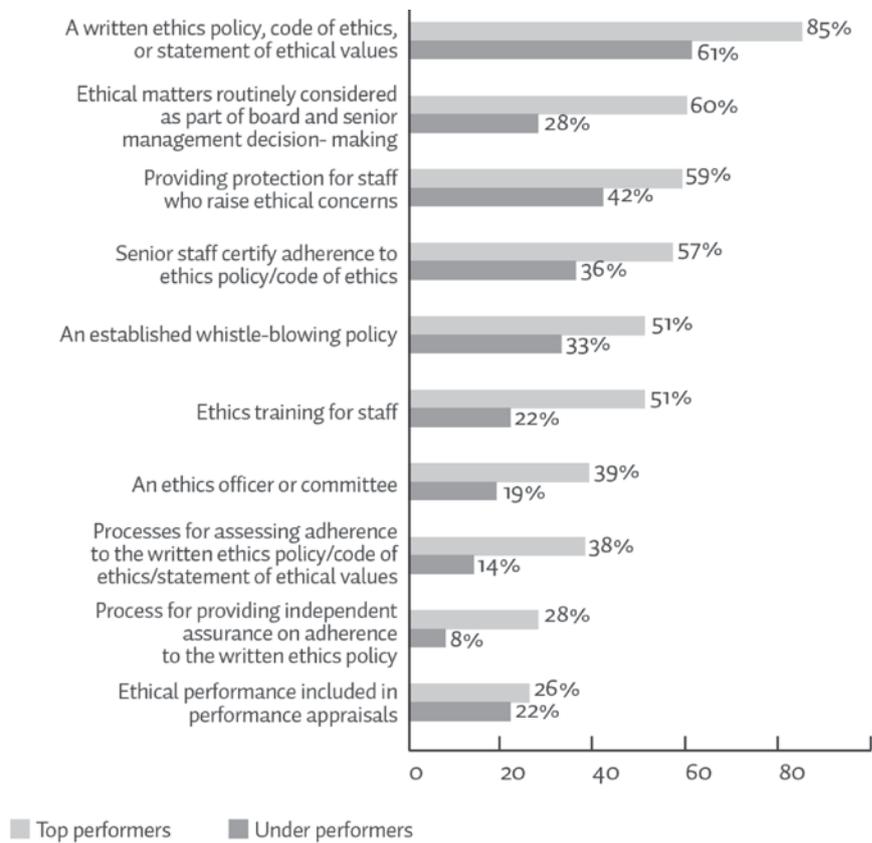
Moreover, CFOs said that a strong ethical culture has a beneficial effect on business performance in terms of staff trust, loyalty and motivation, more reliable financial reporting, and improved corporate culture; and it also boosts external relationships such as those with investors, customers and analysts. CFOs also perceived a risk to their personal and corporate reputations if they did not give ethics a high enough priority.

22. K. Ug Oji, N. Dando and L. Moir, *Does Business Ethics Pay?*, IBE, 2007. <http://www.lbe.org.uk>

23. http://www.accaglobal.com/documents/governance_ethics.pdf

Figure 4: Extracts from *Corporate Ethics and the CFO: Balancing Principles and Profit in the Public Eye* (CFO Europe research services)





Of course, a correlation between ethical practices and good financial results is no proof of a causal relationship. It could be argued that top-performing companies will inevitably tend to be well-run and hence more likely to introduce ethics training and the like than poorer performers. As Michael Clifford, CEO of the Al Fahim Investments company in Abu Dhabi commented:

I think there is a clear linkage between the two [success and ethics] although making the case that there is an explicit pay-off from a good ethical environment may be difficult to prove. The existence of good ethics is evidence of proper organisational stewardship and employee culture and the maturity level of a business.

In practice though, are companies genuinely committed to ethics or is it simply a case of obeying regulations and staying out of trouble? As Richard Aitken-Davies, ACCA deputy president at the time of the CFO survey, said:

US CEOs are noticeably more confident about their ethical performance than other regions, but the backdrop there, with the shadow of Enron, the Sarbanes–Oxley requirements, the Corporate Fraud Task Force and the threat of Federal Sentencing Guidelines for wrong-doers represents more of a ‘push factor’ than other regions face.

Nasser Al Mughairy, managing partner, Abutimam (Grant Thornton) in Oman, pointed out that there was little evidence of change in terms of ethical approach among either large, privately held businesses or SMEs since the 2007 financial crisis, as these entities did not have to face compliance monitoring from the regulatory authorities. This was unlike listed companies, he said, which had introduced a much clearer link between ethics and risk management and were ‘taking it more seriously’.

It could be argued that, ultimately, it matters little whether a more ethical approach comes from within or is brought about by regulation, as long as the improvement happens in practice. But it is pleasing that the large majority of respondents believed that there was evidence that good ethics pays, although as we have seen, there are also many examples where a lack of ethics pays, at least in the short term.

Edgar Zhi, CFO in ABN Amro bank in Shanghai, said ‘definitely, these two [business success and ethics] are highly correlated and I think there is a causal link between the two.’ While Steve Li, Financial Controller at Accuserve (also in Shanghai) said: ‘In the long term, good business ethics helps a company to build up its good public image and goodwill. That will bring continuous revenue streams to the company and thus a better bottom line.’ It is also noteworthy that some banks, such as HSBC, appear to have done relatively well through the crisis by tempering profit with prudence. Some have made the point that it may be no coincidence that HSBC’s chairman, Stephen Green, is a committed Christian with a strong interest in ethics.

The regulatory, legal and cultural environment must always be borne in mind when comparing companies’ commitment to business ethics. Denny Ngai, CFO at Staple China, said it was important ‘to take into account country ethics versus corporate ethics, especially for countries where relationships still supersede some ethical regime’. And a roundtable of business leaders convened by ACCA in Zimbabwe also argued that a coherent ethical framework was particularly important to guiding behaviour in difficult business environments: ‘Morals should come first – otherwise success will be short-lived. In dysfunctional economies engaging in unethical behaviour has greater incentives’.

Investors also tell us they care about ethics. Their interest increased post-Enron, and again since 2007. Investors would like to assess what is often called ‘tone at the top’ and would like to be more active in looking at their investees’ ethics. The practical difficulty, of course, is how to evaluate ethics in an organisation. Few companies attempt to do this for themselves and clearly it is that much harder for third parties to form an opinion, although at time of writing there is increasing discussion about whether such ‘tone at the top’ could be externally verified or even audited. Kenneth Henry, ACCA member and accounting professor at Florida International University said: ‘there should be ways of independently auditing assertions made by management. You would look at the policies, procedures and governance arrangements put in place to back up those assertions’. The challenges of how a company can ensure its own ethical health are discussed in section 16.

13. Elements of good risk management

It will be clear from the discussion so far that good risk management must give greater attention to understanding culture and what drives behaviour, sometimes referred to as the 'control environment'.

It can be argued that risk management and compliance in banks became a mathematical exercise which for all practical purposes ignored human nature. We have, hopefully, now learned that risk management is just as much an art as a science. For the CRO of a financial institution, the most important things now are culture and its related risks.

Effective risk management comprises the following.

- Understanding the control environment, including the competence of the board and staff, the culture, key motivators and the ethical climate.
 - Understanding the company's strategy and purpose and the associated risks.
 - Understanding of the business model, the value drivers, the systems and their associated risks.
 - Balancing risk against reward.
 - Efficient business processes, including management and financial reporting systems.
 - Compliance with relevant requirements.
 - An appreciation that risk management is not about managing individual risks, but about understanding patterns of risk and how they are interrelated.
- Understanding all the significant risks threatening, or potentially threatening the company, including those which might kill it.
 - The board and the company's attitude to risk and their willingness to accept it.
 - The ability to manage risks so they are within limits of acceptability.
 - A process of feedback involving monitoring and learning, so that strategic and other key decisions are taken only where the risks are understood and acceptable.
 - In any complex large organisation, an independent assurance function that gives objective assurance, to the board or the non-executive directors, on each of the above elements.
 - The board having ownership of, and strong commitment to, risk management, including a clear understanding of the above elements.

A holistic understanding of risk is essential. If we liken a company to a 50-floor building, it is important that risk is considered at each floor. The best view of risk will probably be gained from the top floor or the roof, but problems could also exist below ground. Other risks can arise from activities on each of the floors. It is important to know who and what you let into the building. It follows that risk should be considered across the whole organisation and taking into account its place in the environment. Scenario planning of risk is highly desirable.

14. Reporting

We made the analogy earlier of sunlight as the best disinfectant – for reporting as the best means of preventing undesirable behaviour within a company. Objective, balanced and clear reporting both within a company and externally is therefore vitally important, not only for boards but also for shareholders and other stakeholders. It is also an essential ingredient of accountability and of stewardship.

Reporting, both within an organisation and externally to shareholders and other stakeholders, is helpful in many other ways. Quite apart from the benefits of communicating information to the recipients, reporting helps the preparers by helping to focus their minds. Management, reporting to a board, is clearer about what they are doing, and a board reporting to stakeholders becomes clearer about its own achievements or lack of them. ACCA is pleased that the incoming UK government in May 2010 announced its intention to reintroduce the Operating and Financial Review (OFR) – a development predicted earlier in the year, at an ACCA round table meeting, by Steve Maslin, head of external professional affairs at Grant Thornton. The aim of the OFR is to give a comprehensive and forward looking account of the business to shareholders ‘through the eyes of management or the board’. The process of drawing up such a review should be as informative to the board, particularly the non-executive directors, as it should be to shareholders.

The financial reports of banks are long and detailed, and it is often difficult to ‘see the wood for the trees’. Standard setters are attempting to reduce their complexity. But at the same time, audit reports are sometimes criticised for being short on specifics, and shareholders and other stakeholders often say that they want more information on a wide range of matters, many of which are not directly about financial issues.

As noted above, banks’ problems were rooted in behaviour. At present, we do not have a generally accepted process for assessing or reporting on behaviour, and few companies attempt to do so. The *UK Corporate Governance Code*, however contains a number of principles which are really about behaviour. For example, the first main principle and supporting principle of the Code says this.

A.1: The role of the board

Main Principle

Every company should be headed by an effective board which is collectively responsible for the long-term success of the company.

Supporting Principles

The board’s role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed. The board should set the company’s strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance. The board should set the company’s values and standards and ensure that its obligations to its shareholders and others are understood and met.

All directors must act in what they consider to be the best interests of the company, consistent with their statutory duties.

ACCA would like companies to provide clear information about how they apply these principles, because they go to the heart of the board’s role and to the heart of governance. ACCA would like shareholders to insist that such information is provided and use it as a basis for engagement with the board. As we have already noted, few companies address ethics or values in their annual reports, and it should be particularly illuminating to read how boards set a company’s values and standards and how they ensure that these are reflected throughout the company.

We have noted elsewhere that external reporting also focuses the mind; for example, the Turnbull requirements on internal control focused audit committees on risk management. Many have said that this was more valuable than the compliance requirements of Sarbanes–Oxley Rule 404 on reporting on internal financial control. The EU’s initiative to require companies to report on their treatment of ‘stakeholder’-related factors, such as the environment and corporate governance arrangements, is also worth mentioning in this context, as is the UK’s initiative to require listed companies to discuss the main environmental trends and factors which are likely to influence the development of the business in the future.

In South Africa, the King Code of Governance Principles²⁴ goes further than the UK Code and other countries’ governance codes in setting out the ethical responsibilities of companies and their boards. The King Code, which like the UK Code, is based on the ‘comply or explain’ concept, calls on companies to issue an integrated report which represents their performance in terms both of its finances and its sustainability. The King Code states:

by issuing integrated reports, a company increases the trust and confidence of its stakeholders and the legitimacy of its operations. It can increase the company’s business opportunities and improve its risk management. By issuing an integrated report internally, a company evaluates its ethics, fundamental values, and governance, and externally improves the trust and confidence which stakeholders have in it.

Box 2 sets out some of the principles and best practice which the King Code expects companies to follow and set out how they do so.

Both the UK Code and the King Code refer to the board’s responsibility to set the company’s values. In the UK, reporting on this area is relatively new. Companies are beginning to include statements of their values in their annual reports, and a few go on to set out how these values are implemented. We are grateful to the Institute of Business Ethics for drawing our attention to an example from the annual report of Balfour Beatty (see Box 3).

24. *King Report on Governance for South Africa*, Institute of Directors of South Africa, 2009.

Box 2: King Report on Governance for South Africa

Ethics involves three key, interlinked concepts – ‘self’, ‘good’, and ‘other’. Thus, one’s conduct is ethical if it gives due consideration not only to that which is good for oneself, but also good for others. ‘Business ethics’ refers to the ethical values that determine the interaction between a company and its stakeholders

The Code consists of principles and recommended practice. Principles 1.1 and 1.3 are particularly noteworthy:

Principle 1.1: The board should provide effective leadership based on an ethical foundation

Recommended Practice

Ethical leaders should:

- 1.1.1. *direct the strategy and operations to build a sustainable business;*
- 1.1.2. *consider the short- and long-term impacts of the strategy on the economy, society and the environment;*
- 1.1.3. *do business ethically;*
- 1.1.4. *do not compromise the natural environment;*
- 1.1.5. *take account of the company’s impact on internal and external stakeholders;*
- 1.1.6. *be responsible for the strategic direction of the company and for the control of the company;*
- 1.1.7. *set the values to which the company will adhere as formulated in its code of conduct;*
- 1.1.8. *ensure that its conduct and that of management aligns to the values and is adhered to in all aspects of its business; and*
- 1.1.9. *promote the stakeholder-inclusive approach to governance.*

Principle 1.3: The board should ensure that the company’s ethics are managed effectively

Recommended Practice

The board should ensure that:

- 1.3.1. *it builds and sustains an ethical corporate culture in the company;*
- 1.3.2. *it determines the ethical standards which should be clearly articulated and ensures that the company takes measures to achieve adherence to them in all aspects of the business;*
- 1.3.3. *adherence to ethical standards is measured;*
- 1.3.4. *internal and external ethics performance is aligned around the same ethical standards;*
- 1.3.5. *ethical risks and opportunities are incorporated in the risk management process;*
- 1.3.6. *a code of conduct and ethics-related policies are implemented;*
- 1.3.7. *compliance with the code of conduct is integrated in the operations of the company; and*
- 1.3.8. *the company’s ethics performance should be assessed, monitored, reported and disclosed.*

Box 3: Extracts from Balfour Beatty's Annual Report 2009

While we focus on driving the business forward in difficult markets, we also need to maintain a clear view of our culture, our values and the elements that make up our licence to operate. We have produced a new Code of Conduct for all our employees and are working hard to uphold a common culture based on the shared values of integrity, teamwork, excellence and respect.

Show leadership in our values and behaviour

To be the leading provider of infrastructure services, we will need to act like a leader – setting the industry standard for ethics, safety, sustainability, and in relationships with customers, the supply chain and our people. Leadership is not just about having the biggest market share. Infrastructure is about long-term investment and we need to demonstrate that we have a long-term perspective. Having a common set of values that represents the Group offers clear business benefits and will support the challenges of future growth.

Why is this important?

In our business, success is built up over decades – but can be undone very quickly by inappropriate business behaviour. As our business becomes larger, more diverse and ever more complex, we need to reinforce a clear culture and values that enable everyone to manage complexity and make decisions that consistently protect both our finances and our reputation. Knowing what we all stand for will sustain us through the challenges of future growth as we enter new market sectors and integrate further companies. It will also help customers to see that the Balfour Beatty brand delivers consistent behaviour when we build teams from different parts of the Group. At a time of rising global concern over corruption, we also recognise that companies which are seen to have the highest ethical standards have a clear competitive advantage.

What are we doing?

We are working to ensure that all parts of the organisation recognise and uphold a common culture based on shared values. Following extensive consultation with customers, suppliers, joint venture partners and employees and building on existing best practice within the Group, we identified these values as crucial: integrity, teamwork, excellence and respect.

Shared culture and values

The common thread running through most aspects of our strategy is the need for shared culture and values. This impacts particularly on our ability to integrate capabilities for customers, to share knowledge and capabilities, to leverage our scale and maximise efficiencies and to show leadership in our values and behaviour. Our ability to operate in a joined-up way that is consistent across the organisation, matters particularly for major customers who work with us on a multiplicity of contracts and projects and is essential if we are to deliver the benefits implicit in a long-term partnership relationship.

Group ethics and values

Balfour Beatty has enjoyed considerable growth over the past decade. We believe that having a common set of values that represent the Group will offer clear business benefits and will support the Group through the challenges of future growth. During 2009, we refined our ethical principles and redefined the Group's core values.

We want our shared values of integrity, teamwork, excellence and respect to drive behaviour and prioritisation across our business. These values will be embedded throughout the Group in 2010 as part of an extensive roll-out programme. A direct product of the values is the new Code of Conduct. This sets out the principles by which employees are expected to translate the values into everyday actions and decisions. A new ethics helpline to allow employees to raise any concerns they might have has also been set up.

Supplier engagement

We work in partnership with those suppliers who adopt our values as their own and seek to align their objectives with those of Balfour Beatty. We undertake rigorous checks on the financial strength, health and safety and sustainability record of our supply base to ensure that we do not become over-reliant on any particular business.

In 2010 our priority is the further embedding of the values programme and the launch of a Code of Conduct e-learning module.

15. An ethical approach – HR aspects

We have suggested that, while ethical considerations are essential elements of any risk management strategy, it is for each individual business to determine what they are and how they can be most appropriately adopted. Nonetheless, we suggest that the following basic elements are highly desirable:

- The recruitment of senior executives and financial staff who have a strong ethical compass should be made a priority, and
- Integrating a strong ethical culture into the organisation; this process should aim to include the adoption of a clear corporate commitment to following unambiguous and verifiable standards of conduct.

RECRUITMENT

Since, ultimately, it is people who make decisions within organisations, the effectiveness of any set of rules or code of practice will always depend on the competence and integrity of the individuals with the authority to make those decisions. An ethics-based framework emphasises the importance of having individuals, especially in more sensitive roles, who can be trusted to make sound judgments and to observe any set behavioural approach.

At the most elementary level, appropriate checks on the background and character of applicants should always be carried out. The focus and extent of these checks must be in proportion to the type of post that is being filled. In addition to taking steps to verify information provided by a candidate concerning their competence and qualifications, checks may in some circumstances need to be carried out into a person's eligibility to fill the post concerned and into their backgrounds. More sophisticated and focused assessments of a person's fitness and propriety will be called for in respect of senior roles, particularly in sensitive sectors.

In the wake of the banking crisis, regulators are increasingly acknowledging the importance of 'character' issues in the corporate sector. The UK's FSA has adopted a new, more 'intrusive' policy which is designed to ensure that those who aspire to assume so-called Significant Influence Functions (SIFs) within authorised firms meet its test of fitness and propriety (the FIT test). This test involves assessing candidates' suitability against three sets of criteria:

- honesty, integrity and reputation
- competence and capability
- financial soundness.

In addition to the above criteria, the FSA will also, where appropriate, take into account non-technical skills and behaviours, particularly in relation to an individual's perceived ability to play their role in delivering 'effective governance' and their willingness to work with it in an open and cooperative manner. The FSA stresses that 'appropriate behaviours are often critical to the delivery of effective performance in a key regulated role'.

The reasons why an external regulator will wish to ensure that senior executives are fit and proper are not dissimilar to why the company itself should want to do likewise. A regulator will be concerned to ensure that the persons in charge of a company have the competence, experience and personal qualities which minimise the risk that the company's actions will cause undue detriment to the interests of other players in the market. The company for its part has every reason to be sensitive to the same risk, with the additional concern about direct detriment being caused to the interests of its shareholders and employees. If, as is today widely accepted, a company's reputation in the marketplace is a key risk factor, it necessarily follows that a company should be striving to integrate a candidate's fitness and propriety into the recruitment and development process. In saying this it is important to stress the need to differentiate clearly between moral behaviour (that is, behaviour which seeks to follow standards of individual morality, which may or may not be religiously based) and ethical behaviour (behaviour which is driven by an acceptance of the need to respect the interests of other parties in formal relationships). While it is arguable that the former will influence the latter, the first is not a necessarily a pre-condition of the second.

If, as we believe, ethical behaviour can be ‘role-modelled’, how can we ensure that CFOs and senior financial managers have this strong ethical compass? It has been suggested that the possession of this quality is demonstrated by a willingness and ability to do the following three things well when making a decision:

- Confer with all stakeholders, in order to understand their attitude to the issue, their business practice around it and their aspirations about it.
- Appraise as fully as possible the impact of a course of action on the natural resources to be influenced by the decision.
- Take full account of all this information in the decision-making process.

INSTALLING AN ETHICAL CULTURE WITHIN THE ORGANISATION

Individuals within an organisation can only be expected to comply with ethical norms if it is made clear to them what standards are expected. On a personal basis, they may be subject to external expectations of their behaviour, for example their religion or their membership of professional organisations, which lay down ethical standards. But any such external influences will invariably not be sufficiently comprehensive or focused to cover the whole workforce, or the range of situations likely to be encountered in the workplace. It follows that it must be the responsibility of the business to prescribe the standards and the practices that it expects from its whole workforce, and to ensure that it integrates those standards and practices into all aspects of its operations through a dedicated workplace culture.

A culture is a framework of behaviour which incorporates values and principles, and is thus more than a mere statement of expected conduct. Integrating a culture into the practices of a workplace involves ensuring that all individuals within the workplace understand the values, accept them and apply them in everything they do in their roles. This necessarily requires that top management not only understands and accepts them but leads by example in setting the right tone.

16. How do we know if we are being ethical in business?

The King Code, referred to earlier, says that companies should measure adherence to ethical standards and assess, monitor, report and disclose their ethics performance. This is easier said than done. If it is problematical in the first place to define what we mean by 'ethics' and 'ethical behaviour' in the business context, any company which wishes to align itself with any benchmark of ethical conduct will need to visualise exactly how ethical practices will look in the particular circumstances of its business. This will be especially useful if the business's code of conduct is expressed in generalities rather than specifics.

The new *UK Corporate Governance Code* says that corporate governance is 'about what the board of a company does and how it sets the values of the company'.

The UK Institute of Business Ethics (IBE) published a paper²⁵ aimed at helping organisations in gaining assurance on whether they were living up to their values. Following extensive input from the main UK accountancy bodies (ACCA, CIMA, ICAEW and ICAS) and from the Institute of Internal Auditors in the UK and Ireland, the paper sets out the issues to be addressed. At the time the paper was written (2006) there were very few examples available of best practice in this area. We were aware of no company that had a comprehensive approach, but we could offer examples of good practice in particular areas. The publication is available from the IBE and should be a useful reference for any organisation thinking of establishing a process to assess whether it is living up to its values.

25. N. Dando and W. Raven, *Living Up to Our Values – Developing Ethical Assurance*, IBE, 2006.

The main impetus for developing assessment methodology in this area has come from the US, probably as a result of the US Federal Sentencing Guidelines; these stipulate that penalties for executives found guilty of misdemeanour will be less severe if it can be demonstrated that the company has an effective Ethics and Compliance Programme in place.

A comprehensive approach to implementing an Ethics and Compliance Programme that includes assessing ethical culture and performance is set out in the Open Compliance and Ethics Group (OCEG) *Red Book 2.0*.²⁶ The OCEG is a US-based not-for-profit organisation which has developed an assessment framework following input from dozens of organisations and individuals (including ACCA). In addition to the framework below there are tools available to assist in evaluating the various framework elements (see Figures 5 and 6).

The OCEG framework is complex, and the guidance on its implementation covers hundreds of pages. A simpler example of a practical benchmark tool is set out in Box 4. We are grateful to Eoin McCarthy for permission to include it.

We have emphasised the importance of values and their influence on behaviour. The example in Figure 7, developed by Richard Barrett,²⁷ illustrates one approach to assessing the values of an organisation and comparing them with what might be the optimum. We are grateful to Malcolm Lewis for permission to include it.

Figure 5: GRC Capability Model – high-level view of OCEG Red Book 2.0

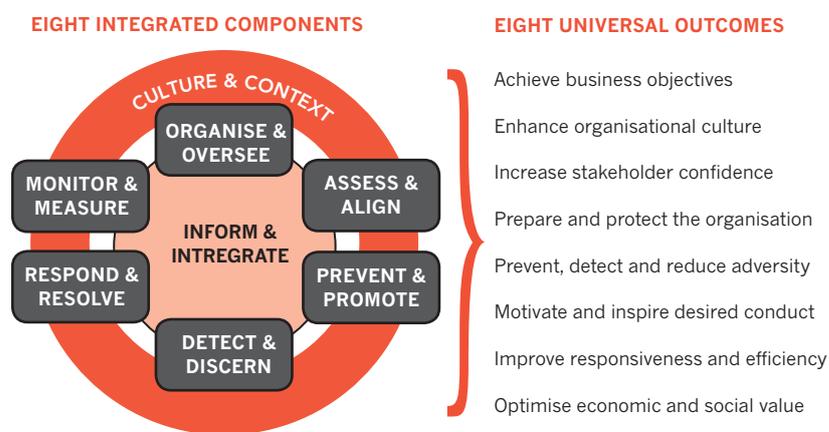
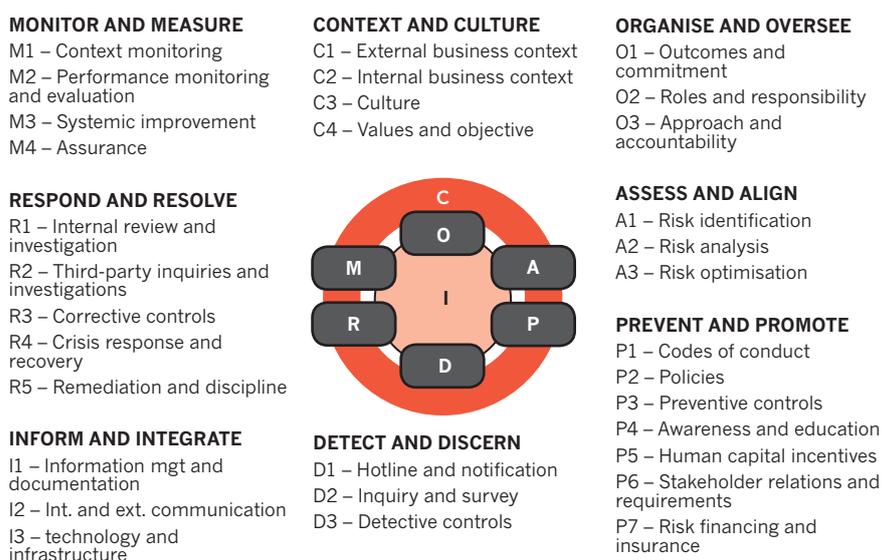


Figure 6: GRC Capability Model – expanded



26. *GRC Capability Model 'Red Book' 2.0*, Open Compliance and Ethics Group, 2009. <http://www.oceg.org>

27. Richard Barrett, <http://www.valuescentre.com>

Box 4: Essentials of good business ethics

■ **Walk the talk**

We do what we say we will, what we lead our stakeholders and society to expect of us. Individual executives consciously attend to this declared purpose and its responsibilities, including profit. They create and maintain a (common) understanding of how to deliver these. They behave only in alignment with this understanding: performance matches purpose as closely as possible.

We pay as agreed: 30 days is 30 days, 60 days is 60 days.

We avoid deceptive pricing.

We pay our taxes in the jurisdiction in which the profit is made.

We avoid coercion and exploitation.

We add value as reliably and consistently as possible.

■ **What you see is what you get**

In our investments, we are clear and open about our risk-taking policy. Stakeholders are always able to be confident they are up to date with the potential up-sides and down-sides to all our activities.

■ **Listen [to], hear, and respond to our stakeholders' evolving agendas**

The executives inform themselves of, and respond adequately to, local communities' and society's evolving expectations of our business. They demonstrate conscious intentions to deliver to stakeholders' expectations as well, and as consistently, as possible.

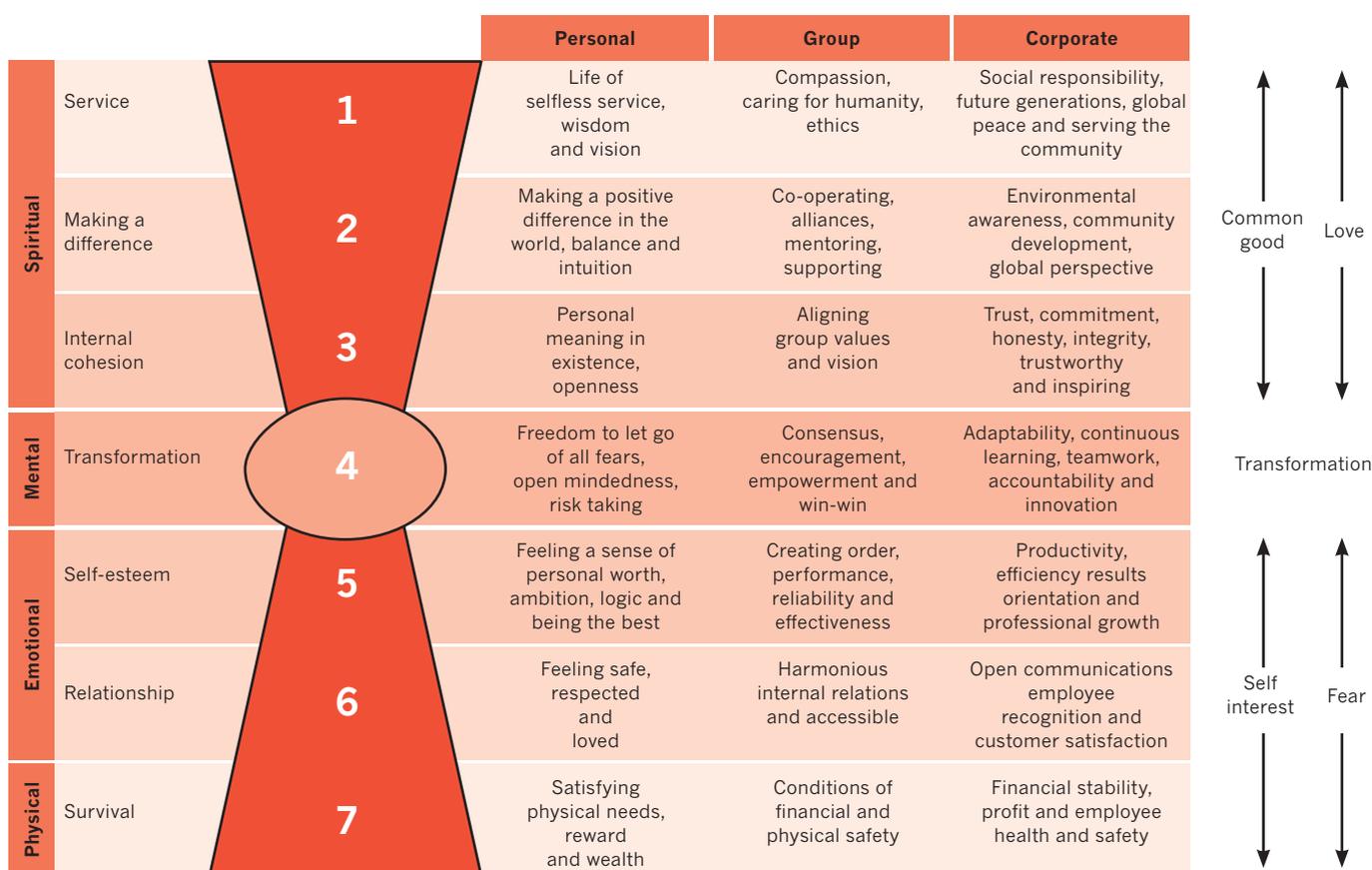
■ **Be open and honest**

We exercise maximum possible transparency in strategy and policy implementation, with due respect for individual dignity, sustaining the environment, and being fair with suppliers and customers:

■ **Ensure governance is fit for purpose**

We are seen to comply with the relevant codes or we explain our non-compliance. We clearly identify, acknowledge and respect all our stakeholders. In addition to declaring governance costs, board members declare their rewards.

Figure 7: Seven levels of consciousness (awareness)



Notes

Richard Barrett developed this framework for learning about the values held by people in an organisation, their perception of the values of that organisation and their view of what would be an optimal set of values. This can provide a useful basis for engagement and for creating a culture which is better for the business. This ‘Seven Levels of Consciousness (Awareness)’ model, adapted from Maslow’s Hierarchy of Needs, has been used around the world. The premise is that a healthy culture requires positive values at each of these levels.

The personal, current corporate and desired corporate values as assessed by employees, and potentially by other stakeholders, are mapped on the model allowing an assessment of the ‘state’ of the particular culture, comparison with individuals’ values and with a consensus view of a more ideal culture. This enables management to see whether they have the values and culture they positively desire or if it is negatively affecting performance.

It can be noted that the values often considered most important to a company, such as financial stability, profit and employee health and safety are at level 1. According to Barrett, values located in levels 1–3 on the model tend to be ‘fear’ driven and can restrict growth to higher levels. If there is too much fear then positive values such as profit tend to be replaced by negative ones such as silo-mentality, bureaucracy etc. Barrett terms an excess of negative over positive values as ‘entropy’. Failure to address this will mean the culture could overheat like an engine. Ignoring this is not a solution as key staff will leave, become ill or simply become ineffective.

Values located in the higher levels of consciousness are considered to be of the mental and spiritual (not necessarily religious) kind, where people tend to hold the values most precious to them. Tapping into what people desire the organisation to feel like is meant to help deliver hard business strategies and results.

17. Conclusion

In this paper we have analysed some of the theories, the practice and the inter-relation of risk, ethics and governance and how these can be harnessed by businesses to improve stakeholder value. It is clear that these issues have moved up the corporate agenda over the past three years, but practical improvements are far from universal.

We have seen that effective regulation and monitoring by regulatory bodies have an important role to play, but that there are clear limits to what those processes can achieve. They need to be accompanied by a genuine commitment to ethical behaviour by businesses, starting at the top. Companies need to assess how they can translate externally imposed rules and codes into meaningful ethical conduct in their own environment.

Compliance with regulations is important (not least for protecting the interests of stakeholders) but companies will only be willing to go beyond a 'tick-box' mentality if they see the bottom-line benefits of an ethical corporate approach. So it is encouraging that there is a growing (though not yet wholly conclusive) body of evidence which points to a link between ethical behaviour and business success. But companies which remain wedded to a narrow and short-term view of shareholder value need to be aware that in the modern regulatory, political and business environment such an approach will come under increasing strain.

ACCA is itself committed to encouraging ethical behaviour, both as an institution and among its membership (see Appendix 2). But we are also keen to engage with governments, regulators, businesses, investor groups and others in the ongoing debate over risk, ethics and governance, to which this paper is a contribution.

Appendix 1: contributors

ACCA wishes to acknowledge the contributions of the following individuals to the production of this paper.

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Appendix 2: ACCA and ethics

ACCA regards ethics as being at the very centre of what being a professional is all about. There is an enormous difference between being a member of a professional body, with its responsibility to work in the public interest, and just being a member of a club. Employers tell us that they value the increased emphasis on ethics and governance in our post-2007 qualification. They see ethical behaviour and governance as being a core skill set of accountants, in the same way as financial reporting, management accounting or tax. And we agree.

In 2007 ACCA redesigned and strengthened the Professional-level qualification to include a much greater emphasis on professionalism and ethics. That has been achieved in several ways.

First of all, every new ACCA registrant is now introduced to the accountancy profession, and to the importance of ethics and professionalism, through an interactive filmed sequence which focuses on their importance. The film sets out the rights, responsibilities and obligations of the professional accountant.

Secondly, ethics and professionalism are assessed in 11 of the 16 papers in the ACCA qualification syllabuses, so that the examiners can assess the ethical dimensions of technical capabilities.

ACCA has also developed its own online ethics module, which is a first of its kind, and which will genuinely prepare students to become accountants who are professional in the true sense of the word. After the accounting scandals of recent years, it is vital that the accountants and financial professionals of tomorrow are equipped to operate in an industry that will continue to be subject to close scrutiny.

The online nature of the module is particularly important, as it means that students around the world will have equal access to it – we have always championed the cause of distance and online learning because it opens opportunities and widens access. The online *Professional Ethics* module has already been completed by thousands of students around the world who have given very positive feedback. Completion of the *Professional Ethics* module is essential for ACCA membership.

One of the new features of the ACCA qualification, launched in 2007, is a greater articulation of work

experience requirements with the examinations, where the work-related performance objectives are tied more closely to the examinations. In addition, ethics and corporate governance have been introduced into the practical experience requirement as mandatory elements.

The most significant development in the ACCA qualification is the introduction of a professional-level examination in professionalism and ethics, *The Professional Accountant*. The syllabus covers corporate governance, internal control and compliance, risk and ethics and professional values. In response to findings obtained from employer surveys, from June 2011 ACCA will introduce more emphasis on risk at the professional level of the qualification, by adding new outcomes on the management of business and financial risk.

ACCA is introducing professionalism and ethics into its Foundations in Accountancy suite of qualifications, which underpin the ACCA qualification. From December 2011, any Technician-level qualification will require students to have successfully completed the *Foundations in Professionalism* module, which covers such matters as what it means to be a professional, and the legal obligations on accountants in the areas of fraud, money-laundering, health, safety and security. The module also assesses fundamental principles, personal effectiveness and personal ethical values through an interactive case study about a small business.

ACCA's stance on ethics, in compliance with IFAC standards, is therefore to ensure that, at all stages of the student's journey towards professional membership, and all through their qualifying and training, ethics and professionalism are at the core of the process.

It does not stop after qualification. Since 2006, all ACCA members must demonstrate that they are keeping their professional skills and knowledge up to date. Under ACCA's continuing professional development (CPD) scheme members must submit evidence annually to verify that their CPD objectives have been achieved, and one of the core requirements is a statement, or commentary, about fulfilling their ethical responsibilities. In this way, ACCA is endeavouring to make sure that its members continue to be 'fit for purpose', demonstrate fundamental professional values and conduct themselves ethically and responsibly at work.

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