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Ethical Culture More Important Than Ever

Recent pronouncements by both the Securities & Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) and the results of new research have further accentuated the need for business to increase its focus on maintaining a culture that values ethical and legal business conduct very highly. Regulatory bodies and many stakeholders, including the general public and shareowners, continue to insist that companies must conduct their business operations with integrity, honesty, and trust.

Additionally, evidence continues to accumulate that ethical companies perform better financially than others. Corpedia, a compliance and ethics consultant company, created the Ethics Index to track the stock performance of publicly traded companies that are recognized by researchers for their ethical cultures, among other things. Companies on the Index have outperformed the S&P 500 by more than 370% over the past five years.

Also, I have personally conducted research over many years demonstrating the fact that companies who are recognized as good corporate citizens—those who consider the interests of employees, customers, the environment, and their community as well as those of shareowners—perform significantly better on a financial basis over the long term. Firms that pay attention to ethics and employ compliance initiatives that assure their conduct harmonizes with their core values build greater customer loyalty; attract and retain superior, more productive employees; and achieve lower costs of capital through greater investor confidence.

From a compliance perspective, the need for effective ethics initiatives is true for smaller and larger companies. The "Application Notes" from the U.S. Sentencing Commission state: "As appropriate, a large organization should encourage small organizations (especially those that have, or seek to have, a business relationship with the large organization) to implement effective compliance and ethics programs."

In another area of ethics application, the requirement in Section 404 of the Sarbanes-Oxley Act (SOX) for management assessment and external auditor attestation of internal control over financial reporting has been extremely controversial. The excessive cost of implementing this particular provision has been widely criticized. In response, both the PCAOB and the SEC have engaged in nearly five years of dialog that has consisted of commentary, discussion, and both public and private meetings involving internal and external auditors, corporate executives, academics, and other interested parties, such as IMA®.

The SEC issued its final interpretive release, No. 33-8809, on June 20, 2007. Titled "Amendments to Rules Regarding Management's Report on Internal Control over Financial Reporting (Corrected)," the release provides guidance for management to evaluate and assess internal control over financial reporting in a more effective and inexpensive manner. Its purpose is to set forth an approach by which management can conduct a top-down, risk-based evaluation. In other words, the SEC recommends that the most cost-effective method of compliance with Section 404 is to focus mainly on significant risks and entity-level controls—or, as the Committee of Sponsoring Organizations of the Treadway Commission (COSO) refers to them, "the control environment."

The SEC pronouncement emphasizes the importance of risks and related ethics and compliance by defining entity-level controls as aspects of an internal control system that have a pervasive effect on that system, such as controls related to the control environment (for example, management's philosophy, operating style, integrity, and ethical values; board or audit committee oversight; and assignment of authority and responsibility); controls over management override; the company's risk assessment process; centralized processing and controls, including shared-service environments; controls to monitor results of operations; controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs; controls over the period-end financial reporting process; and policies that address significant business control and risk management practices.

The SEC goes on to affirm the importance of entity-level controls by stating: "If management determines that a risk of a material misstatement is adequately addressed by an entity-level control, no further evaluation of other controls is required."

Concurrent with the growing realization of the importance of a company's risk management processes and effective ethics and compliance programs is the need for better assessment of their effectiveness. Earlier issues of this column have made suggestions—see, for example, "How Good Is Your Ethics and Compliance Program?" in the April 2007 issue or "Ethics and Compliance Best Practices" in June 2007.

A survey by Pricewaterhouse-Coopers (PWC), titled *2007 State of the Internal Auditing Profession*, found that only 20% of the organizations that conduct more than one type of enterprise risk assessment consider the objectives of those assessments to be aligned well. Also, 64% of organizations either only update their risk assessments on an ad hoc basis or have no specific methods to trigger a revised assessment.

The 2007 LRN Ethics and Compliance Risk Management Practices Study is a global survey of 161 senior executives (90% are in the U.S.) who have primary responsibility for ethics and compliance initiatives. The survey was conducted by ethics and compliance consultants LRN, and the report contains similar opportunities for improving ethics and compliance processes. Several survey findings are of interest to management accountants.

Only half the respondent companies integrate risk assessments of ethics and compliance with other risk assessments. Only 42% obtain input from executives, and 37% obtain it from business managers. Ethics and compliance are very often a part of the legal function. The legal department is involved in performing the ethics and compliance risk assessment in 78% of the cases. Legal and compliance department involvement occurs 85% of the time, and legal and internal auditing involvement occurs in 79%. Ranking or mapping of risks

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uncovered during the risk assessment takes place less than half the time.

Despite the regulatory mandate for encouraging an ethical corporate culture and an effective compliance program, the LRN survey shows that only 65% of U.S. companies report reaching all of their employees with ethics and compliance education. Another 27% report they reach a majority of employees. Suppliers and partners are the groups least targeted for education, with only 20% being reached.

Consistent with the results of earlier research, the most important method used for reporting compliance violations is a confidential reporting channel, such as an anonymous telephone line. On the other hand, the greatest reported challenge for detecting ethics and compliance violations is that employees aren't comfortable reporting incidents. Almost 40% of companies believe their employees fear retaliation despite the availability of anonymous reporting technology, according to the LRN report.

Based on the total failure of whistleblowers to obtain protection from discrimination under the provisions of SOX Section 806, perhaps employees still have good reason to fear retaliation. Of the nearly 1,000 complaints filed under SOX 806 in the five years since its enactment, not one person has survived the appeal process and won his/her case.

The vast majority of SOX 806 cases have been dismissed as having no merit by the Department of Labor's Occupational Safety and Health Administration, which administers this provision. Some 270 cases have resulted in settlements, but only six survived the first level of appeal—an administrative law judge. The first to be heard at the highest appeal level, the Labor Administrative Review Board, was overturned in favor of the employer. It just doesn't seem possible that not a single one of these cases had any merit.

It appears that perhaps Sarbanes-Oxley may indeed have broken parts that need major fixing, but the fix should be to strengthen provisions of the law, not to weaken the entire statute, as its critics and some business groups have demanded. ■

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