Take a ***Cost-Benefit Approach*** *to* **ETHICS**

By Joshua Atlas, CMA, CFM, CFE

One of the primary responsibilities of accounting and finance professionals is to measure relevant quantitative metrics and communicate their results and implications clearly so management can use them to make informed business decisions.

Unfortunately, ethical decisions often escape the detailed eyes of such rigorous analysis. Too many people, accountants included, view ethics as a separate sphere beyond normal business analysis. Ethical decisions, however, can and must be subjected to at least the same level of cost-benefit analysis as other crucial strategic business decisions.

Most people who champion ethical behavior exhort business leaders to make principled decisions because "it's the right thing to do." Rarely do they provide concrete, quantitative reasons for their arguments. On the other hand, too many managers only consider certain explicit costs of unethical behavior, such as potential fines or legal actions. What is sorely needed in the business community is an honest accounting of all the likely repercussions of either taking the ethical path or ignoring it. It's definitely worthwhile to consider some of the specific costs and benefits associated with both following and ignoring ethically based decisions.

Costs

Ethical Approach

Costs of ethical decision making include setting up, maintaining, and potentially expanding internal audit and compliance functions; employee resources expended on creating an appropriate internal culture; and, perhaps most significantly, forgone business opportunities. Given that management's prime responsibility is to maximize profits, one of the most difficult decisions an executive can make is to forgo a seemingly lucrative deal in the name of ethics. The company indeed may suffer from decreased revenues, profits, and strategic positioning in the short term.

Unethical Approach

Costs of *not* following ethical imperatives are manifold. First, there's the often-thought-of potential of explicit outlays of cash in the form of fines and legal judgments when the organization is found to be guilty of some regulatory or legal breach. Newspaper headlines love to highlight these explicit costs, especially in some of the most expansive cases. In many circumstances, the amounts can be consequential. For example, in 2012 alone, the Securities & Exchange Commission (SEC) charged Eli Lilly and Company $29 million for improper payments, charged Pfizer $45 million for illegal payments, and settled Tyco International's illicit-payments-related charges and Justice Department criminal matter for $26 million. (See www.sec.gov/spotlight/fcpa/fcpa-cases.shtm.) Yet many pundits, such as ABC News with regard to BP, argue that such fines are treated merely as a cost of doing business. (See http://abcnews.go.com/blogs/headlines/2010/05/bp-fines-simply-a-cost-of-doing-business.) To the extent this may have some inkling of truth, many managers and their financial support teams, unfortunately, only get this far into their cost-benefit analysis without recognizing additional, potentially staggering costs to their organizations.

The discovery of unethical actions tarnishes or destroys the organization's brand and general reputation, which in turn weakens connections with customers. Consumers may abandon the organization or at least demand price reductions to assuage their burdened consciences (leading to substantial reductions in revenue for the tarnished brand). BP represents a prime example of the effect negative publicity can have on a brand. According to BrandFinance.com, BP's brand value fell a whopping $7.4 billion, or 61%, by August 4, 2010, because of the Deepwater Horizon oil spill that occurred April 20, 2010. (See www.brandfinance.com/news/in_the_news/bps-brand-value-sinks-dramatically.)

Untarnished competitors may gain a strategic competitive advantage over the unethical organization by differentiating themselves as the ethical choice, or the least unethical choice, available in a given industry. Examples abound of companies actively promoting how ethical they are so they can achieve strategic gain, even within such generally controversial industries as oil and gas. For instance, Chevron is highly promoting its "Human Energy" and "Finding Newer, Cleaner Ways to Power the World" campaigns (www.chevron.com) to focus the public on the value it provides to society even as competitor BP is still trying to rebuild the company's brand after the Deepwater Horizon oil spill.

Also, vendors may cut ties completely or raise prices to mitigate their own reputational risks, jeopardizing the flow and cost structure of critical supplies. Substitute industries may capitalize on the situation by meeting consumers' needs through alternative products or services.

Employees undoubtedly will read cues from management and begin to make unethical decisions of their own, often at the expense of their employers, or they will voluntarily leave the organization to protect their own integrities, thus raising the cost of retaining productive human assets. These financial impacts shouldn't be overlooked. For lower-paid employees, "the average cost of replacing an employee amounts to fully 20 percent of the person's annual salary," and losing executives can cost "up to 213 percent of the employee's salary." (See www.cbsnews.com/8301-505125_162-57552899/how-much-does-it-cost-companies-to-lose-employees.)

Benefits

Ethical Approach

Benefits to holding the ethical line mostly appear as the inverse to the costs of not keeping to ethical standards. An ethical organization—with a reputation as such—can differentiate itself among competitors, securing a larger market share and earning a higher price point with consumers. *The Wall Street Journal* conducted its own related experiment and found that "…if you act in a socially responsible manner, and advertise that fact, you may be able to charge slightly more for your products" and that "…it appears to be even more important to stay away from goods that are unethically produced. Consumers may still purchase your products, but only at a substantial discount." (See http://online.wsj.com/article/SB121018735490274425.html.) This robust relationship with customers drives a stronger negotiating position with suppliers, who will want access to the largest players in the industry.

More employees will stick to ethical principles, knowing they have the backing of management, and many will be proud to work for such a virtuous employer, leading to reduced turnover and steadfast commitment. In one survey, according to Robert Vaux of Demand Media, "94 percent of those surveyed said that it is extremely important to them that they work for an ethical company." He also brings up the relevant point that "Employees who feel loyalty to their business are less likely to engage in theft or similarly take advantage of their employer, according to the Online Ethics Center." (See http://smallbusiness.chron.com/ethics-affect-productivity-work-10167.html#gsc.tab=0.) Of course, with no ethical lapses, the explicit costs of fines and legal judgments disappear as well.

The recent expansion of *Forbes*' Most Ethical Companies lists magnifies the financial impact of these benefits as more parties become aware of an organization's ethical standing. It's revealing that the companies on the 2010 list of Most Ethical Companies "outperformed the Standard & Poor's 500 by delivering a 53% return to shareholders since 2005, significantly higher than the S&P, which has been down 4% in the same period." (See www.forbes.com/2010/03/22/ethisphere-ethical-companies-leadership-citizenship-100.html.) Regarding the 2013 list, "Companies find that ethical business practices increase their competitiveness in their respective industries, helping to further substantiate the notion that a culture of ethics is crucial to sustainable excellence." (See www.forbes.com/sites/jacquelynsmith/2013/03/06/the-worlds-most-ethical-companies-in-2013.)

Unethical Approach

The benefits of behaving unethically, on the other hand, consist mostly of short-term boosts to revenue and profit because of immediate cost savings or revenues generated. The problem with these gains is that they can be sustained only until the organization is caught.

If one unethical lapse isn't discovered immediately, this may lead to a distinct bias in risk analysis by management. Management might weight further unethical conduct as unrealistically profitable. Soon they will involve the organization in myriad instances of illicit conduct, exponentially increasing the probabilities of exposure. Once the truth is revealed, the costs mentioned earlier will afflict both management and the organization as a whole.

Implementation

When management strategically decides to chart an ethical course for the organization, several concrete actions need to take place. Management should adopt a strongly worded and well-publicized code of ethical conduct to which everyone must strictly adhere. It also must set clear lines of communication for reporting potential ethical lapses, which possibly could include an independently run ethics hotline. The code shouldn't be limited to high-minded principles but should also include specific guidelines on how employees should act in situations they may experience, given their particular industry. All employees should sign a printed version of the ethics policy; dealing with tangible documents fosters a deeper psychological commitment than simply clicking a button on a computer. Companies also should hold a short, in-person, annual training session that everyone must attend, including management. This is the only way to show and emphasize how seriously the organization considers ethical conduct. (See http://businessfinancemag.com/article/creating-ethical-bottom-line-0525.)

Anyone seeking to strengthen ethical conduct should take advantage of the *IMA® Statement of Ethical Professional Practice* (the *Statement*), which is a powerful resource found on IMA's website (www.imanet.org/pdfs/statement%20of%20Ethics_web.pdf). The *Statement* presents broad yet actionable principles and standards for professionals to abide by and then follows up by prescribing a specific, detailed route toward resolving potential ethical dilemmas. An individual company or organization may want to provide further thorough directions tailored for its particular industry, but the *Statement* should offer a solid basis for any further refinement.

Making the Best Choices

Accounting and finance professionals need to utilize their quantitative tools to investigate and analyze ethical decisions, including them as crucial pieces in their organization's profitability calculations. Only after the true financial costs and benefits of choosing to follow or ignore ethical practices are incorporated into profit-maximizing decisions will management make the best choices. **SF**

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