



ACCOUNTING MATTERS

Fostering an ethical organization from the bottom up and the outside in

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Abstract Despite the best efforts of corporate compliance officers, boards of governance, auditors, and regulators, corporate misconduct continues to plague our markets. In this thought-provoking installation of Accounting Matters, we argue that efforts to fight fraud and other forms of corporate misconduct have failed, in part, due to the systematic approach employed toward a problem that is irregular, complex, and extends well beyond the boundary of the firm. By drawing upon research from the field of behavioral ethics to suggest a new approach that does more than just stress formal control systems, we illustrate how executives may strengthen organizational ethics through informal practices that work from the ‘bottom up’ and the ‘outside in.’ Our review includes practical recommendations regarding how to create shared responsibility for ethical leadership, how to empower employees to achieve both economic and ethical ends, how to enlist the aid of key stakeholders in identifying problems before they grow and spread, and how to redesign compliance practices to address the complex nature of corporate misconduct.

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1. New ideas in corporate compliance

It has been more than a decade since the Enron and WorldCom fraud scandals changed the face of accounting and corporate compliance in America. Thanks in part to these failures, businesses must now comply with a whole host of regulatory

measures designed to protect shareholders from corporate misconduct. Even with these safeguards in place, however, the headlines continue to profile case after case of unethical behavior in business. Executives who have invested time and money in new control systems, whistleblower hotlines, and ethics training programs have good reason to wonder if there is anything else that can be done to protect firms from the kinds of unethical behavior that destroy value, ruin corporate reputations, and undermine employee morale.

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Recent research from the field of behavioral ethics suggests that efforts to fight fraud and other forms of corporate misconduct have failed, in part, due to the systematic approach employed toward a problem that is irregular, complex, and extends well beyond the boundary of the firm (Senge, 1993; Weatherford, 2002). Few fraudsters have criminal backgrounds, making standard background checks an ineffective measure for screening out bad apples (Association of Certified Fraud Examiners, 2012). Moreover, the most expensive frauds are perpetrated by members of the management team, who have the ability to override control systems and collude to cover their tracks (American Institute of Certified Public Accountants, 2005). Certainly, having strong control systems, careful procedures, and mechanisms in place to detect and deter fraud are important, but these formal systems are only the beginning. New evidence suggests that informal practices, cultural norms, and the active participation of key stakeholders may actually matter more when it comes to fostering ethical business practices and preventing fraud (Tenbrunsel, Smith-Crowe, & Umphress, 2003).

Building on this new understanding of the roots of organizational ethics, scholars have developed a new model of corporate compliance called *ethical infrastructure*: the formal systems, informal norms, and work climate associated with ethical decision making (Tenbrunsel et al., 2003). This model embodies an expansive view of corporate governance in that it includes both the formal aspects of ethics systems, such as codes of conduct, training, and whistleblower programs; and the informal elements, such as open discussion of ethical dilemmas and other ethics-related norms that are visible only to those within the organization's boundaries. Together, these formal and informal systems support the development of the kinds of decision making, learning, and knowledge transfer routines that sustain a positive ethical climate and facilitate effective ethical organizational performance.

Next, we outline six considerations for executives who seek to enhance their compliance efforts by embracing the concept of an ethical infrastructure. These recommendations build upon a foundation of strong formal control systems to address the informal ways that organizations may foster organizational ethics from the bottom up and the outside in.

1.1. Thinking beyond 'tone at the top'

Unquestionably, ethical organizations cannot thrive without the support of the top leadership team. The concept of 'tone at the top' has become an integral part of corporate compliance efforts today, and a

key consideration for investigators when weighing penalties for corporate misconduct. Tone at the top matters because leaders shape followers' behaviors and beliefs (Brown, Treviño, & Harrison, 2005). In order for employees to take codes of conduct and other compliance efforts seriously, they need to know that leadership takes these matters seriously, as well. Moreover, organizational compliance efforts may be seriously undermined when executives fail to 'walk the talk,' thereby giving others in the organization implicit permission to also disregard compliance programs when it suits them.

We agree whole-heartedly that strong ethical leadership is the backbone of organizational ethics. What we want to challenge, however, is the common assumption that ethical leadership is the responsibility of those at the top of the organization. When companies emphasize the importance of tone at the top but fail to also stress the importance of ethical leadership throughout the organization, they inadvertently foster the psychological drivers that allow unethical behavior in an organization to go unchecked. Too much emphasis on tone at the top sends the message that leadership alone is responsible for ethics, thus fostering a diffusion of responsibility and a 'not-my-problem' attitude that allows employees to follow their natural tendencies toward non-intervention. Instead, we believe that every employee has a responsibility to demonstrate ethical leadership.

We encourage executives to embrace the principles of ethical leadership throughout their organizations by redefining ethics and compliance as a line responsibility as opposed to simply a staff function. This idea of a shared responsibility for organizational ethics is not to suggest that ethics and compliance functions be eliminated, but rather that employees outside of this function can and should be held jointly responsible for implementing and monitoring ethics and compliance-related activities. As Colin Dyer, CEO of Jones Lang LaSalle, once remarked: "If ethics isn't everywhere, it's nowhere." One useful way of thinking beyond tone at the top involves the concept of distributed leadership. *Distributed leadership* conceives of leadership as a set of functions carried out by the group rather than as the exclusive domain of those at the top of the organizational hierarchy (Gibb, 1954). Today, scholars are extending this idea of leadership as a distributed, emergent phenomenon of shared influence to include an ethical component, as well. Distributed ethical leadership exists where all employees share responsibility for demonstrating a commitment to ethics and organizational values.

How do organizations foster organizational ethics from the 'bottom up' using distributed ethical

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