Putting Codes in Perspective

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Remarks on Viviana A. Zelizer's article

Viviana Zelizer's focus on codes of ethics is surprising. In her paper "Ethics in the Economy," she argues that the study of formal codes and their effects can help us understand how economic actors respond to ethical questions, and she outlines a code-centered research agenda directed to this end. My perspective is rather different. Although I am interested in codes and have done research on code content (Paine et al. 2005), I have found that formal codes often have little to do with a company's response to ethical questions. Certainly, a formal code can be useful. It can serve as a guide to conduct, a reference point for decision making, or a tool to communicate with the public. But if I were trying to predict a company's ethical stance, I would give relatively little weight to the presence or absence of a formal code. Far more important would be the company's leadership and culture, the structure and design of the organization, and the institutional context within which the company was operating. For these reasons, the research agenda I would recommend differs radically from that proposed by Professor Zelizer.

My perspective is perhaps explained by a case study that was for many years a staple of the ethics curriculum at the Harvard Business School. The case describes the wealth of earnings management techniques that the H. J. Heinz Company used in the 1970s and 1980s to shift sales and expenses from one reporting period to another – techniques such as soliciting false invoices from suppliers, withholding documents from the accounting system, and recording current expenses as capital expenditures (Goodpaster/ Post 1981). Throughout this period, the company had a formal code of ethics explicitly forbidding many of these practices, and managers even filed annual certificates of compliance with the code. What the company also had, however, was a culture in which missing your financial targets was deemed "a mortal sin" and a compensation system that rewarded executives for reporting consistent year-to-year earnings growth according to a rigid pre-determined formula. Each year, targets were ratcheted upward by precisely 15 percent, regardless of market or other conditions, and each year, managers who delivered their numbers were awarded the promised compensation, regardless of their adherence to the code. In other words, the formal code was just that – a formality. A similar conclusion emerged when I informally polled some 20 companies roiled by accounting misdeeds in the summer of 2002. Of

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the ten that responded to my query asking whether they had a formal code of ethics or values statements, all but one said "yes".

The opposite point can be illustrated by another example – HDFC, one of India's most highly regarded financial services companies (Paine et al. 2001). Although HDFC is widely known for its ethical practices, humane workplace, and contributions to the broader community, the publicly-traded company's top managers had explicitly chosen not to adopt a formal code of conduct (or, for that matter, a formal mission statement) as of 2000, when I studied the company. In fact, many employees seemed to take pride in the absence of a formal code. Speaking of codes and mission statements, the then managing director noted,

> "[They] are put out there often enough, but never lived. We would rather live it, and that is what our founding Chairman did (…). He believed in simplicity and humility, and that is what he has passed through to our organization." (Paine et al. 2001: 1)

The founder also made it a point from day one that HDFC would be transparent in its finances and reject "speed money" from customers seeking special treatment.

To be clear, this is not an argument against codes. As noted, codes can be quite useful, and I recommend that companies adopt them for a variety of reasons (for a company that takes its code seriously, see Paine/ Wruck 1998). In fact, some sort of code is almost a legal necessity in the United States, given the New York Stock Exchange listing requirements, the Sarbanes-Oxley Act, and the Federal Sentencing Guidelines for Organizations. Nonetheless, codes are only one of many factors that shape a company's response to ethical questions. For better indicators, it is necessary to go behind the formal codes and policy statements and to examine the fundamentals of the organization and how it is managed. Although a full analysis is beyond the scope of this short commentary, let me mention three factors that I would highlight based on my field work over the past two decades (for further discussion, see Paine 2003). If I were research czar doling out funds for projects, I would put money into these areas.

The first is the quality of leadership. An organization's response to ethical questions often mirrors the response of its leaders. Not always, of course, given the size and reach of today's companies. In today's far-flung global enterprises, many employees never see their company's leaders, let alone interact with them on a personal basis. And, as Zelizer points out, rogue individuals and sub-groups are quite common. Nevertheless, leaders exert a powerful influence on behavior throughout an organization – not only through their personal example, but also through the decisions they make, the people they appoint to office, and the systems and processes they put in place. It is noteworthy that the problematic practices at Heinz originated with a top management decision to "adjust" earnings to avoid reporting high profits during a period of wage and price controls. The chosen technique: inflating expenses by soliciting false invoices from suppliers. Even without an explicit directive from on high, the notion managed to spread across the company's various divisions, geographies, and functions. By the same token, in a typical corporate hierarchy, this cascade effect means that if a leader requires his or her lieutenants to provide, for instance, an ethical analysis of a proposed plan of action, the lieutenants, in turn, will require the same of their subordinates and so on down the line.

Contrary to conventional opinion, my experience suggests that the ability to deal with ethical questions is not simply a matter of the leader's character – although character certainly counts. It is also a matter of skill and knowledge. Many business leaders do not know very much about ethics. In contrast to economics, which many have studied at the college level, ethics is unknown territory, and many are unfamiliar with basic concepts of the discipline or even the great traditions of ethical thought. Lacking a vocabulary and general understanding of the field, it is not surprising that executives are often uncomfortable with the topic (see, e.g., Jackall 1988), shy away from talking about it (see, e.g., Bird/Waters 1989), and rarely engage in systematic ethical analysis of the decisions they face.[1] Indeed, a survey done by accounting firm KPMG suggests that some managers lack even the rudimentary skills involved in identifying and dealing with misconduct,[2] let alone the more complex ethical issues that arise in most organizations. I am not making the familiar point that the "tone at the top" affects an organization's response to ethical issues. Rather, I am suggesting that "skill at the top" is also an essential factor. At any rate, this is a hypothesis worth exploring more systematically. If true, it would suggest that business schools and in-house leadership programs should devote more time to developing these competencies.

A second factor is the design of a company's compensation system. Recurrent features of the ethical breakdowns I have studied are perverse incentives that arise from linking pay to overly simple or otherwise problematic performance measures. Code or no code, money is a powerful motivator, and people – from top executives to front-line employees – generally want to achieve the goals that their bosses set out for them. Thus, if the goals are misaligned with true value-creation, they can easily lead to behavior that is ethically (and economically) problematic. Again, Heinz is a case in point, but more recent examples, such as Enron, are readily at hand. Such cases suggest that the ethics question cannot be effectively addressed separately from the compensation question and that ethics-related criteria must somehow make their way into the performance measurement process if ethical issues are to be taken seriously. Of course, this further implies the need for methods of tracking and evaluating ethics at the individual, business unit, and company levels. Here, then, is a second fertile area for research: the relation between ethics and compensation systems.

Finally, I would mention the importance of the institutional context in which a company is operating. Institutional factors, such as the quality of the legal system, the reliability of the press, and the effectiveness of government, all play a crucial role in shaping a company's response to ethical questions. In the absence of well-functioning

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1 Consider the remark by David Komansky, former CEO of Merrill Lynch speaking at the World Economic Forum in 2002, and brought to my attention by Joshua D. Margolis: "We're trained as businessmen but we're being asked to pass judgment on the moral and ethical value of these projects". Quoted in Schmemann (2002).

2 Only 64 per cent of employees are confident their CEO and other senior managers would respond appropriately if they were to become aware of misconduct according to the KPMG LLP 2000 Organizational Integrity Survey cited in The Conference Board (2003: 23).

institutions, it is extremely difficult for even the best-intentioned and most capable leader to foster ethics within the organization. If corrupt rivals can operate in secret and without fear of legal or governmental reprisal, the ethical company will often be at a competitive disadvantage and may even be driven out of business. Research could help us better understand this dynamic and how it can be addressed.

Formal codes can give us insight into espoused or desired norms of behavior, but to understand actual behavior, especially how to foster behavior that conforms to the espoused norms, we must look beyond codes. If our aim is research that contributes to better practice, I would recommend more focus on the issues outlined here – leadership quality, organization design, and institutional effectiveness.

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