CHAPTER 1

Introduction

To see what is in front of one's nose needs a constant struggle.

—George Orwell

Themes

So, with some niceties dispensed with, let's spend time on the overarching themes that you should keep in mind as we go through this discussion. The first is that your organization is not perfect, nor will it ever be. There will always be some risk involved. With employee turnover in the range of 10 to 20 percent per year, you will always be adding new dynamics to the mix of your personnel structure. This obvious fact goes to the point that you need to be looking at the ethical makeup of your organization constantly in the same manner and rigor you review financial performance.

So it is important to understand what you can control and what you cannot control. To keep it simple, there are three basic types of unethical behaviors. The first is the "lone wolf," that is, someone acting alone in a position of trust and in an area of their expertise. Embezzlement is typical of this problem. It is hard to stop the determined lone wolf. The good news is that the damage is *usually* minimal. The slightly better news is that this unethical behavior is not "structural." It is the ethics equivalent of getting struck by lightning. Bad luck, but you move on. We will talk about ways—in the context of preventing more substantial problems—to minimize risk. A determined person, however, will be difficult to spot. That is, until they drive the $80,000 sports car to work.

The next type of unethical behavior is the "oops," which is far more common. This is where an employee—loyal, hardworking, and honest—makes a mistake. A big one. A mistake that could get him or her fired. The decision then, on that person's part, is to fess-up or cover-up. The overwhelming temptation is to cover-up and hope for the best. The "oops," like the lone wolf, is usually not fatal or structural. Yet how the scenario plays out will heavily influence future behavior.

The last type is the "conspiracy." As the term implies, it is the effort by more than one individual to perpetuate a fraud. These latter two situations are the primary focus of this book. These situations are the *company killers*. Conversely, they should be the easiest to prevent to a diligent organization: The bigger the conspiracy, the greater the risk to the conspirators that they involve someone who exposes the conspiracy.

Second, while a qualitative concept, ethics can be measured. Ethical and unethical behavior show up in costs, growth, employee turnover, employee satisfaction, and, of course, return on equity. Attitudes can be surveyed and the results compared over time and across your organization. While there is a temptation to dismiss qualitative results as too soft, there are a number of methodologies and tools that can analyze behavior and produce actionable data.

Finally, since this is not fiction, I don't mind revealing a key plot point early. As you read this, keep in mind the notion of "trust." Trust is so important to an organization at the macro- and microlevel that it is essential to discuss upfront. The reason we focus on personal ethical behavior and the aggregate ethical behavior of an organization is because it is the basis of building trust between individuals and between organizations. At the core, trust is the most essential way to reduce cost and build value.

As mentioned in the preface, throughout the book there are case studies and examinations of ethical lapses that focus on the role of the senior executives. I urge you to examine these situations with an eye toward identifying the breakdown of trust in the relationships. This is important because, while trust is a "touchy feely" concept, as senior executives you often do not have enough raw data to understand the facts well enough. In point of fact, where issues of fraud and malfeasance are involved, real facts are even *harder* to come by as they are often covered up or obfuscated by those perpetuating the unethical behavior.

What you are left with is a gut feeling for the situation: Do you trust the facts? Do you trust the statements? Do you trust the individuals? If not, it is time to act.

CASE STUDY — A CFO'S DILEMMA

Years ago, there was a chief financial officer (CFO) of a manufacturing company about to be taken public. Times were good: The company had successfully come out of the development stage and started to ship product, had negotiated relationships with the top resellers in our industry and, in so doing, secured upward of 85 percent of the distribution chain, and the initial reception from the investment banking community was very good. The company was buzzing with excitement—especially as employees and management started to believe their stock options would be worth a fair amount of money.

The accounting group and outside auditors had recently completed the audit of the second-quarter numbers that would be used as the basis for the offering. Summer was upon them and there was a lull in the activity as the company was in the final stages of deciding on an investment banker. Returning from lunch one day, the CFO saw a tractor-trailer at the loading dock. This was good news because it meant the company was shipping product. Taking a quick detour, the CFO asked the manufacturing manager

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where the product, a specialized machine, was headed. "Here," he said. "It is coming back for a software upgrade. It will be going back out in the next day or so." Oh, well, the CFO thought, and headed to his office.

But something nagged at him. The company's processes included a fairly detailed forecast of revenue, and the CFO did not recall anyone forecasting upgrade revenue for the foreseeable future. Later in the day, curiosity getting the better of him, the CFO went back down to the manufacturing manager and asked if he knew if the software upgrade had been forecasted and for when—the CFO's assumption being that this machine was being upgraded early. "No, we are not charging for this. It's included in the sales price. But it is no big deal; it costs us nothing. Plug in a computer and press a button; maybe 20 minutes of work," he said.

The CFO had negotiated the contracts when he was an outside advisor to the company, and he was damn certain that there were no "free" software upgrades. The CFO stated, "I am fairly certain upgrades were not included in the price."

"Beats me, but I know this machine is getting an upgrade."

This could be a very big problem. The company recognized the revenue based on acceptance of the device. If there was an expectation of an upgrade, there could not be acceptance. No acceptance, no revenue. Having just completed the audit, the CFO knew the company had booked the revenue for all machines shipped to date.

The CFO pored over his files, but there was nothing in the files to indicate the upgrade was due. The CFO then tried to contact the head of engineering, but he was away on vacation. The nagging feeling would not go away, so the CFO went down to the head of engineering's office and grabbed the chief engineer's customer file. In it was a letter—a one-paragraph letter—agreeing to the upgrades. The CFO made a copy and went back to his office. Sitting there, the CFO must have read the letter dozens of times looking for a way out. More correctly, he was looking for an easy way out. There was no way around it: The letter meant that the company needed to restate its revenue. Thankfully, the company had not disclosed anything publicly, but that was a silver lining to a very dark cloud. The CFO thought about the financial impact on the company and the delay in the IPO; he thought about the impact on the employees and their stock options; and the CFO thought about his stock options.

The CFO also thought about how he was the only one who knew there was a problem.

On the one hand, it was pretty clear to him there was no intentional mischief. The engineers who started the company did not appreciate the implications of the letter (there was no CFO, controller, or accountant when the letter was signed) and the company had grown from a dozen engineers to a staff of over 100 in two years, so a software upgrade must have seemed trivial in the grand scheme of things. The accounting rule was pretty straightforward; but until the CFO's coincidental run-in on the dock, neither side thought to communicate with the other. There were a thousand reasons why this was an innocent mistake.

But none of that alleviated the impact.

Leadership Point of View

The CFO is faced with a difficult blend of circumstances, yet one that is highly illustrative for our purposes. It is easy to say what should have been done, but the right decision is not an easy one to make. First, there are three things going through the CFO's mind as he sat in his office—three things that were making him choose to shut his mouth. The first was money: The decision to come clean would cost a lot to the company, his fellow employees, and to him. While the first two were very important, let's be honest, the thought of the pot of IPO gold being pushed away weighed heavily on his mind. The IPO payoff was important to him for a variety of reasons: Long hours would be rewarded, a second child was on the way, and that new-car smell is very enticing.

The second thought going through his mind was that he could get away with not speaking up. As a successful

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executive, the CFO would never be accused of having a small ego and the voice in his head was in full chest-puffing mode: He could deflect questions, nuance answers if necessary, and, if worse came to worse, tear up the copy and enjoy plausible deniability. Ego is a critical factor because it told him he would not get caught.

Finally, he was afraid of the consequences of speaking up. What would this do to his standing in the company? Would he get fired? The CFO kept thinking, "This is not my fault," but his conscience would answer, "But it is your responsibility." He did not have to be an ethics expert to realize that he was *not* going to be viewed as a conquering hero. Everyone in the company looked forward to cashing in, and it would be pretty clear that Mr. Goody Two Shoes spoiled the party. In addition, *nobody* would understand why. It was some arcane accounting rule that would not make sense because the cost of the impact far exceeded the cost of the upgrade.

The Conclusion

The CFO reported the situation to the president and was met with that look all CFOs have seen at one time or another . . . the "you have got to be kidding me" look. No one was pleased with the news, least of all the external auditors. Fortunately, there was no consideration given to any alternative and the company restated the financials. The IPO was delayed, pushing it back four months into a much less receptive market, which had a large impact on the financial health of the company and the value of the employee holdings.

In the end, the CFO made the right decision for the simplest of reasons. First, he was confident that he was doing the right thing, and that his boss would support the decision. The company's culture was a "no nonsense," "reality wins" environment. The CFO had seen the approach taken with the numerous engineering challenges the company had to overcome. He knew, too, while there would be a lot of unhappiness with the news, getting that news out and deal with it was the approach the company took when dealing with problems. He was sure this accounting challenge would be no different.

Part of that confidence stemmed from the fact that the company and management were fair to a fault. The company did not apply one set of rules to govern the behavior of lower-level employees and another for senior employees. In fact, it was often the top management who sacrificed for the good of the company as a whole. Further, it was a company built upon past personal and professional friendships and associations, so it was imperative right from the start to make it clear that we are all expected to act and be treated in the same way to prevent factions or cliques from developing.

Finally, the CFO came to the personal conclusion that it is easy to be a leader in good times, but his professional ambition was to be a leader through it all. He had built the accounting team upon the principles of professionalism, and now was the time to step up and show what that meant. He knew standing up for the right thing would build trust in the eyes of his staff, management, auditors, and the investment banker. Doing the wrong thing would destroy that trust. That trust, be it personal, professional, or corporate, could be needed in the future.

The course of action was taken based on three interwoven factors. First, while the situation was very stressful, the CFO was personally comfortable that the organization would be fair and supportive. *Doing the right thing was not a threat to his job.* Second, the behavior of the organization and groups within the organization consistently sought to get things right in every area. The "reality wins" message was hammered home in each department and at every level. Finally, the CEO led the organization with great personal integrity and expected others to act in the same manner. To act otherwise would have been a disappointment. The right decision was made because of individual security, group pressure to always do the right thing, and leadership integrity. Creating this environment is your goal.