

Why Ethics Hotlines Are Considered a Best Practice

A White Paper Prepared by Lighthouse Services, Inc.



9/28/2010

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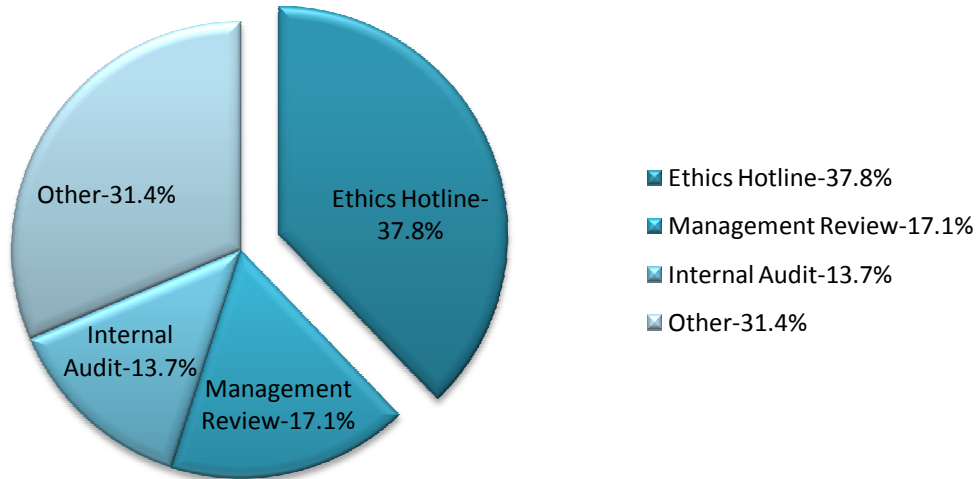
Abstract

The impact of fraud in the workplace can be devastating. According to a two-year study conducted by the Association of Certified Fraud Examiners (ACFE), the median fraud loss for United States companies is \$105,000, with billing improprieties and corruption schemes being the most common methods of fraud perpetration.

Fraud doesn't just occur as a result of schemes concocted by corporate executives, such as in highly publicized cases like the Enron scandal. According to the ACFE survey, 46.2 percent of frauds were committed by lower-level employees, resulting in an average loss of \$50,000.

The ACFE survey indicates that, by far, the most common way companies detect fraud is through the use of anonymous tips received via fraud or ethics hotlines. According to the survey, 37.8 percent of frauds in U.S. companies were discovered through tips, while only 17.1 percent were uncovered by management review and 13.7 percent by internal audit.

Common Methods of Fraud Detection



Source: Association of Certified Fraud Examiners as published in WebCPA,-June 24, 2010

These figures clearly indicate companies that fail to make available an internal anonymous ethics hotline are at greater risk of not detecting fraudulent activity until it is too late. Additionally, an ethics hotline allows employees to report a host of other unethical activities they may witness or personally experience, such as discrimination, harassment, conflicts of interest and time theft, to name but a few.

Companies that seek top performance levels in all areas, including ethical behavior, need to follow what are commonly referred to as “best practices” to ensure that they are on the correct path to achieving their objectives. This paper discusses why an effective ethics hotline is considered to be a best practice for an organization.

To understand why an ethics hotline should be considered a best practice, it is necessary to gain an understanding of the term. Fletcher Challenge Petroleum, an international company that transforms natural resources into petroleum products, succinctly identifies best practices as “management practices and work processes that lead to world-class, superior performance.”

When this meaning is applied to ethics in the workplace, best practices could then be defined as management practices and work processes that lead to a high level of integrity and moral conduct on the part of a company and its employees.

Corporate Scandals and the Call for Stronger Ethical Standards

Attention to ethics in the workplace and the demand for ethics and compliance regulations gained momentum as a result of several highly publicized corporate accounting scandals that occurred in the early 2000s, most notably those involving Enron, Tyco and WorldCom.

Enron

Houston-based energy giant Enron filed for bankruptcy in December, 2001. The company's stock price had plummeted from a high of \$90 per share to \$1 in a little over one year. Unethical accounting practices on the part of Enron and its independent accounting firm, Arthur Andersen, were blamed in large part for the company's downfall. The practices went largely undetected due to the lack of transparency regarding Enron's accounting processes. As a result of the bankruptcy, thousands of Enron employees lost their jobs as well as retirement funds that were heavily invested in Enron stock. Former Enron CEO Jeffrey Skilling and CFO Andrew Fastow, among others, were ultimately sentenced to lengthy prison terms for their roles in the scandal.

Tyco

In 2002, Tyco International CEO Dennis Kozlowski and CFO Mark Swartz were accused of stealing \$170 million from the company and acquiring an additional \$430 million from the fraudulent sale of company stock shares. Kozlowski had been named one of the top 25 corporate managers of 2001 by *Business Week*.

WorldCom

In June of 2002, an internal audit uncovered about \$3.8 billion in fraudulent activities at WorldCom. Eventually, it was discovered that from 1999 to 2002, WorldCom CFO Scott Sullivan, Controller David Myers and Director of General Accounting Buford Yates engaged in a series of fraudulent accounting practices to falsely indicate company growth in an effort to inflate the company's stock value. Estimates indicate that company assets were inflated by as much as \$11 billion.

These are just three examples of corporate improprieties that led to the financial ruin of thousands as well as prison terms for those involved in perpetrating the fraudulent activities.

Introduction of Sarbanes-Oxley

Prior to 2002, the last significant pieces of federal legislation to protect against fraud had been the Securities Act of 1933 and the Securities Exchange Act of 1934. These acts were

implemented by Congress in large part to restore investor confidence as a result of the stock market crash of 1929 that led to the Great Depression. The former set forth requirements regarding the amount and type of information investment firms must provide to potential investors, while the latter established the Securities Exchange Commission (SEC) to regulate the securities industry.

Major Federal Anti-Fraud Legislation



Securities Act of 1933

Securities Exchange Act of 1934

Sarbanes-Oxley Act of 2002

In the wake of financial debacles such as Enron, Tyco and WorldCom, public outcry demanded that the federal government step in and take strong, swift action to prevent these corporate improprieties from occurring again. Under the leadership of Sen. Paul Sarbanes (D-Maryland) and Rep. Michael Oxley (R-Ohio), the Sarbanes-Oxley Act was enacted on July 30, 2002.

In essence, Sarbanes-Oxley (SOX) set forth a host of new standards for corporate accountability regarding financial practices of publicly held companies, as well as penalties for non-compliance. A primary objective of SOX is to eliminate the “I wasn’t aware of it” plea made by CEOs and CFOs during the previous financial scandals. SOX applies to all public companies in the U.S. and international companies that have registered equity or debt securities with the Securities and Exchange Commission.

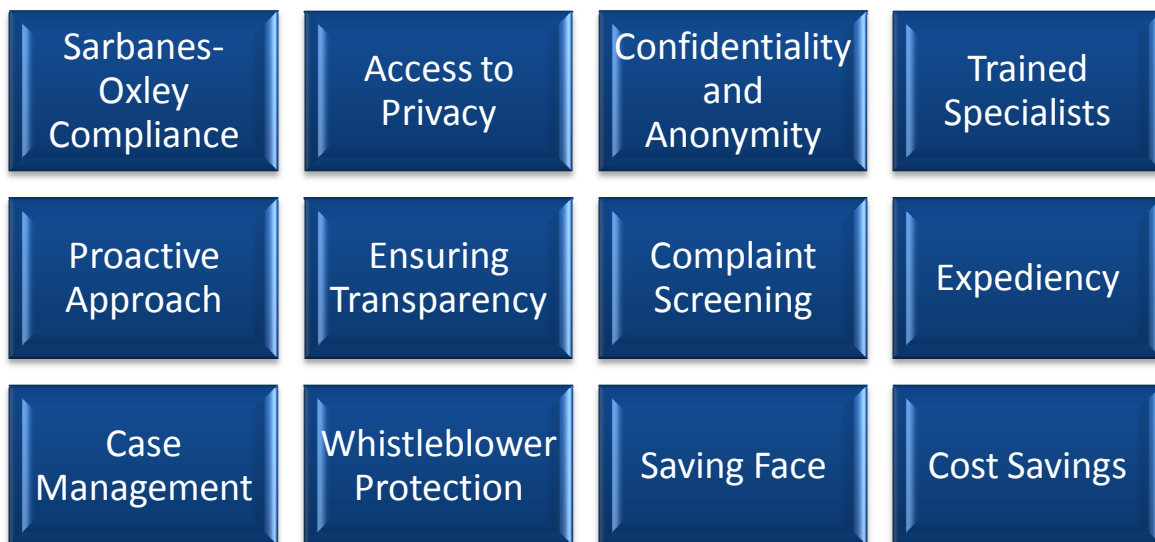
As an outgrowth of SOX, corporations began to look for ways to encourage the reporting of unethical practices before they mushroomed into full-blown scandals. One method of corporate compliance was the implementation of anonymous ethics hotlines.

Best Practices and Ethics Hotlines

An ethics hotline is a method of communication that allows employees who witnesses unethical activities to report them in a confidential manner. In addition to financial improprieties, unethical activities can include sexual harassment, discriminatory practices, intimidation and conflict of interest to name just a few.

There are a number of ways in which establishing a confidential ethics hotline constitutes a best practice:

Ways an Ethics Hotline Constitutes Best Practice



Sarbanes-Oxley Compliance

Sarbanes-Oxley requires public companies to appoint independent audit committees to oversee the procedures for receiving and handling confidential whistleblower complaints.

Specifically, SOX Section 301 requires the implementation of procedures for:

(A) The receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters and

(B) The confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

An ethics hotline helps companies meet these criteria by providing a mechanism for an employee to report irregularities in accounting, auditing or any other ethical issues in an anonymous and confidential manner.

Access to Privacy

Employees who witness or experience unethical practices can understandably be reluctant to engage in whistleblowing while at work, regardless of the promise of the confidentiality of the reporting mechanism. The possibility exists that a phone call might be overheard, a sensitive email might be intercepted or the employee is seen entering or exiting the office of a human resources representative or ethics and compliance officer.

An ethics hotline can eliminate these concerns by providing the employee the opportunity to make a complaint outside of the workplace. The employee will have access to the ethics hotline 24 hours a day, seven days a week, meaning a complaint can easily be filed outside of normal working hours. In addition to a toll-free hotline, the employee can lodge a complaint via alternative methods like fax, email, Internet or postal mail.

Confidentiality and Anonymity

A key component of Sarbanes-Oxley is that employees be provided a method of submitting complaints regarding questionable accounting or auditing practices confidentially and anonymously. By having access to an ethics hotline staffed by an impartial third-party, the employees are assured of reporting irregularities in complete confidence without the need to reveal their name.

Trained Specialists

Human resources workers may be well-versed in many areas of employer-employee relations. However, they may not possess the specialized knowledge to deal with certain ethical issues such as accounting irregularities. A third-party company that deals specifically with ethics in the workplace provides employees with access to individuals who are specially trained in dealing with ethical dilemmas and accustomed to dealing with caller concerns, stress, and frustration.

In addition, these trained specialists are typically required to pass background checks. This provides the employee with the confidence that the person who is receiving the complaint is also of high moral and ethical character.

Proactive Approach

The malfeasances at Enron, Tyco and WorldCom are prime examples of what can happen if unethical practices are not discovered and dealt with early on. In these situations, the frauds were perpetrated over the course of several years, perhaps in part because there was no effective mechanism in place for employees to report their suspicions in confidence. The executives were allowed to “cook the books” at their discretion without having to worry that their activities could be easily detected.

In addition, early detection is a key to keeping the size of fraud relatively small. According to a survey conducted by the Association of Certified Fraud Examiners, the dollar volume of the average fraud that was discovered through a tip (such as through the use of an ethics hotline) was 50 percent less than when reported by other means.

Also, according to Fulcrum Inquiry, employees are often the first to know of financial irregularities before upper management becomes aware of them. If employees have an anonymous means of reporting irregularities, management can find out about them sooner and take corrective action before the fraud can escalate.

Ensuring Transparency

One of the significant features that led to the Enron debacle was the lack of transparency in its accounting practices. According to those who reviewed the company’s various financial statements, the figures the company used to bolster its statement of financial soundness made little financial sense. The use of an ethics hotline can lead to greater transparency and limit the temptation to engage in the practice of “creative financing.”

Complaint Screening

Not all ethical issues are the same, and depending on the nature of the organization, it may have more than one means of handling them. Larger companies in particular may designate that some issues should be handled by human resources while others may require legal attention. The trained representatives offered by a third-party ethics hotline can serve in an effective screening capacity by ensuring that the complaint is routed to the proper company representative, as well as to the ethics and compliance officer for final disposition if applicable.

Expediency

Expediency of complaint handling is another example of how an ethics hotline constitutes best practices. Complainants need to feel that their complaints are being handled and addressed in a timely manner as opposed to being stored in a desk drawer. A reputable third-party ethics hotline will process the complaint and prepare a report, typically within 24 hours of receipt or sooner. The completed report is then promptly forwarded to the designated company representative.

Case Management

Larger companies may receive a high volume of complaints, which can complicate the process of tracking and analyzing hotline reports. As part of its service, an effective third-party ethics hotline includes a Case Management System (CMS) that allows the program administrator to track the complaint from receipt through resolution. Additionally, a CMS allows the administrator to assign the incident for investigation, engage in anonymous dialogue with the complainant, create reports and charts and create an audit trail for added internal control.

Whistleblower Protection

Per SOX Section 806, whistleblowers are provided with protection against retribution from company management or other employees. The act states that a whistleblower who “alleges discharge or other discrimination by any person” is entitled to file a complaint with the Secretary of Labor.

In addition to the legal protection offered by SOX, whistleblowers who may still be uncomfortable reporting ethical improprieties can find additional protection from the confidentiality afforded by the hotline.

Saving Face

The financial scandals of the early 2000s demonstrated that not only can unethical practices lead to a company’s financial ruination; they can also damage its reputation. Early detection of unethical practices through hotline reporting allows the company to take corrective measures before the information can become public.

Cost Savings

According to the Fulcrum Inquiry website, an ethics hotline is one of the easiest and most cost-effective internal control system a corporation can implement. By outsourcing the task to a competent third-party ethics hotline, an organization reduces the need to hire its own staff and pay additional fringe benefits. It also can achieve the savings that comes from eliminating fraud.

Future Implications

There are potential future implications for companies that do not take a proactive approach by implementing safeguards such as an ethics hotline.

According to the Ethics Resources Center (ERC), the organization that conducts the periodic National Business Ethics Survey (NBES) which polls corporate employees concerning ethical issues in the workplace, economic conditions have a direct impact on ethical behavior.

The 2009 NBES collected 3,010 responses from employees across a wide range of industries. Employees reported witnessing fewer occurrences of misconduct in 2009 when compared to the previous NBES in 2007. In 2009, 49 percent of the respondents reporting witnessing unethical acts, as opposed to 56 percent in 2007.

During that same period, the number of employees who indicated they reported occurrences of misconduct when they saw them increased from 58 percent in 2007 to 63 percent in 2009.

In addition, the ERC reported that, by its own measures, the overall strength of ethical workplace culture increased from 53 percent to 62 percent. Employees also reported that the pressure to “cut corners” by committing unethical acts also decreased.

This trend toward the increase in improved ethics corresponds with the decline in the overall economy during that same period. According to the ERC, ethics tends to improve during difficult economic times due to a stronger emphasis placed on ethical behavior by corporate management. Employees who may be prone to unethical behavior may also believe that management is keeping them under closer scrutiny during an economic downturn.

However, the ERC cautions that such improvements are only temporary, according to past history. As the economy improves, corporations become less vigilant, leading to a gradual increase in ethical lapses over time. Conversely, companies that continue to promote a strong ethical culture can continue to maintain a high level of ethical behavior.

In its conclusion to the 2009 NEBS, the ERC indicates that as of 2009, businesses were experiencing what it calls an “ethics bubble.” It cautions that as economic conditions begin to improve, the focus on corporate ethics will decrease and ethical standards will begin to erode.

Among its recommendations, the ERC urges corporate ethics and compliance officers to implement “cultural metrics” to help determine patterns in areas such as the reporting of unethical behavior. The establishment of an ethics hotline can help ethics and compliance officers and human resources professionals take the ethical pulse of the company and implement proactive measures to improve the culture if necessary.

Conclusion

An ethics hotline is considered a best practice for any organization that is concerned about loss from fraud or wants to improve the ethics of its culture. Corporate scandals such as those at Enron, Tyco and WorldCom exemplify what can happen if corporations are not vigilant in policing themselves against the occurrence of fraudulent activities. An ethics hotline provides company employees with a means to report fraudulent activities anonymously and confidentially, which can greatly reduce the fear of retribution that can result from whistleblowing.

Ethics hotlines give employees access to an impartial third-party professional organization whose representatives are trained to handle complaints expediently, thoroughly and with sensitivity. Through the use of a Case Management System, employers have the ability to effectively manage hotline complaints and enhance internal controls.

Companies who are currently satisfied with their level of ethical behavior may be experiencing a false sense of security. As economic conditions improve over time, attention to ethics in the workplace tends to diminish, which can open the door for unethical practices to commence unless a proactive approach is taken.

In summary, companies that are truly committed to best practices, or “management practices and work processes that lead to world-class, superior performance,” must not underestimate the importance of ethics in the workplace. Implementing a third-party ethics hotline is one way a company can demonstrate its commitment to ethical behavior.

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