

Introduction to Business Ethics:

Corporate Ethics - Theory

24. January 2023

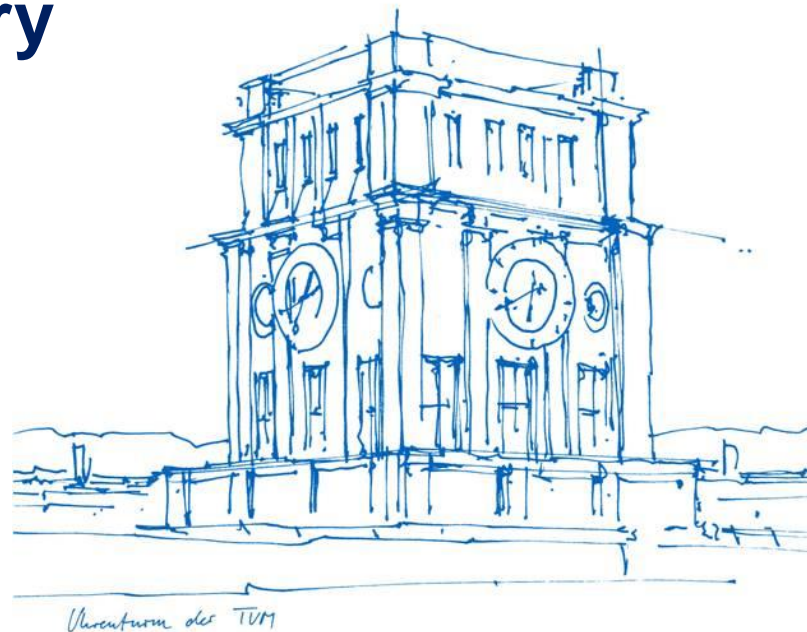
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Winterterm 2022/23



Focus of today

Introduction

Chapter 1: Business Ethics in the Age of Globalization

Chapter 2: Basic Concepts

Chapter 3: Historical-economic Background: Premodernity and Modernity

Chapter 4: Foundations and Tools of Business Ethics

➤ Psychological foundations and tools

~~Chapter 5: Problem Areas of Business Ethics~~

Chapter 6: Corporate Ethics

Agenda

24th of January: Corporate Governance & Compliance + two cases of fraudulent corporations
(Enron and Wirecard)

25th of January: Three Cases: Siemens, Lorry Cartel and Cambridge Analytica

31st of January: Principles and Institutions of Corporate Social Responsibility (CSR)

1st of February: Sustainability Reporting and ESG Rating

7th of February: Guest Lecture by Dr. Andreas Nilsson on Sustainability, Sustainable Finance and
EGS Rating

Dr Andreas Nilsson is Managing Director and Head of Impact at Golding Capital Partners and responsible for impact investments. Prior to joining Golding in 2021, Mr Nilsson was Managing Partner of Sonanz, an Impact-focused fund-of-funds which he founded in 2015. Before that, he worked as a private equity investor at EQT and UBS.

Mr Nilsson holds a PhD in Finance from the Stockholm School of Economics and spent two years as a Visiting Fellow at Harvard Business School. The topic of his doctoral dissertation was “The Financing of Nonprofits and Social Enterprises”. Mr Nilsson earned his MSc from the Stockholm School of Economics.

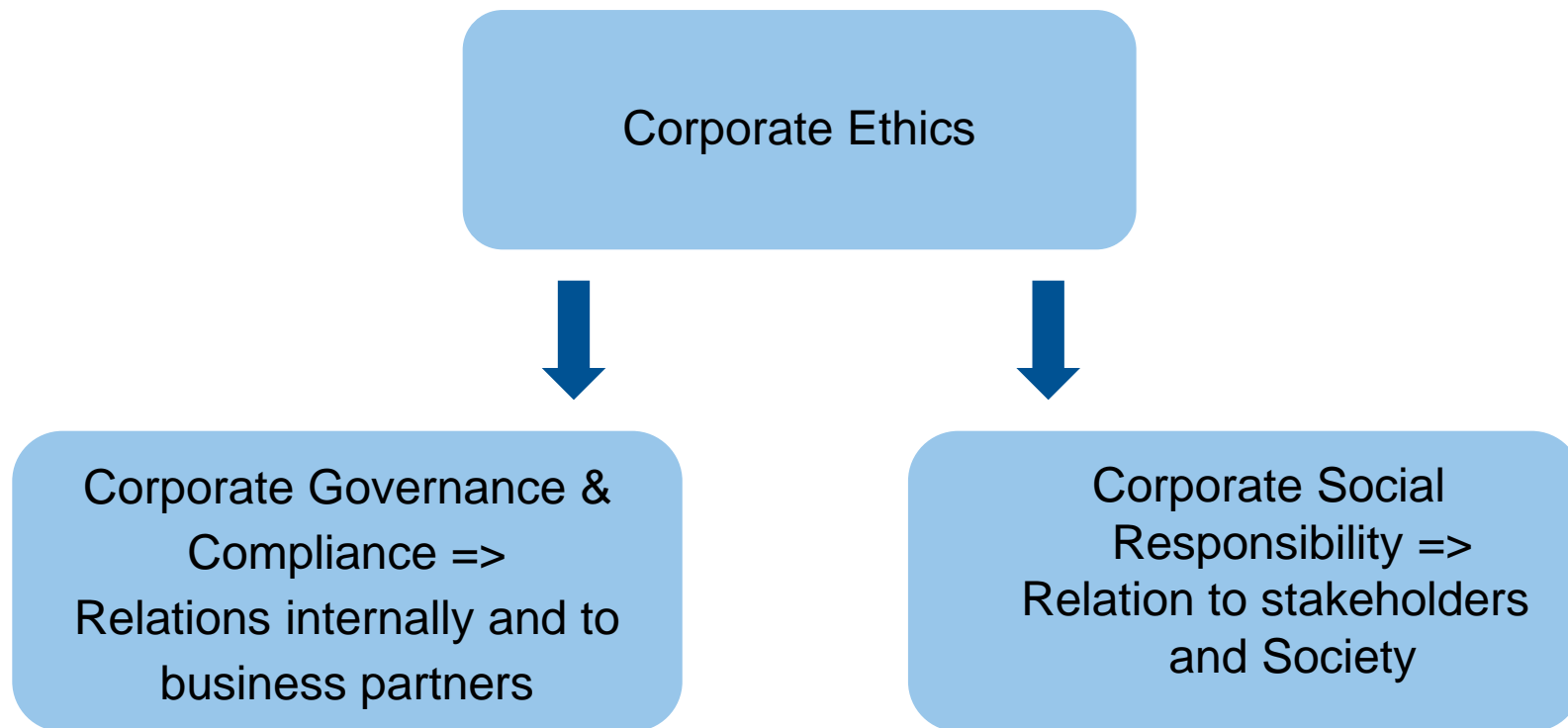


Learning objectives:

Basic insight into the principles of

- Cooperation structures at management level
- Reduction of the risk of mis-management and illegal conduct
- Accommodating the expectations and requirements of society

Slido.com
1174158



Today's lecture

Case illustrated introduction to issues, principles and codes of corporate governance

First case: The fall of Enron

Definitions, concepts and risk mitigation

Second case: Wirecard

Codes of Corporate Governance

Themes of Corporate Governance

Tomorrow's lecture: Three cases of corruption, anti-competitive cartel and abuse of personal data

Bookkeeping fraud

Bookkeeping fraud: Manipulation of annual financial statements in order to give shareholders and the public a incorrect impression of the financial health of a company.

Cases of this and the next lecture show

- why the apparent banalities of good corporate governance principles need to be collectively articulated in corporations
- why explicit management commitment should be imbedded in ongoing communication of values
- how fraud often starts with small misinformation to buy time and in time fraudulent conduct grows out of control

Bookkeeping fraud

The smartest guys in the room believing they could game the system

Enron and Wirecard: Examples of fraud which was revealed. There could be numerous other cases which remain undiscovered

Good corporate governance mitigating risk of incompetence, wrong incentive structures, bookkeeping fraud, corruption, cartels etc

Good corporate governance created transparency, which is not always in the interest of management

Case example Enron 1/6

1985: Founded by merger between gas pipelines Houston Natural Gas and Internorth

1990: Chairman Kenneth Lay hires CEO Jeffrey Skilling and CFO Andy Fastow

1992: Largest gas trader in North America. Beginning of mega-project in India

1996: **Beginning of bookkeeping tricks** "Mark-to-Market Accounting"

- "Mark-to-Market Accounting": the current value of future long-term revenue is counted as present revenue → 2000: \$10.78 billion in revenue reported, but only \$6.27 billion actual revenue

1999: Founding of trading platform "Enron Online"

(Lütge & Uhl: p. 249)

Enron 2/6

Losses were covered up by mis-representation in the book keeping

CFO Andy Fastow created "partner" companies (Special Purpose Entities, SPE) which enabled Fastow to transfer \$30 Billion losses to these fictive companies

The audit firm Arthur Andersen assisted Enron in building this structure

Recording profits and exporting losses to SPEs

Enron 3/6

2000: Stock price reaches all-time high: \$90.56

Oct 16, 2001: Enron admits that accounting rules have been violated; profits were corrected down by 20%

December 2, 2001: Stock falls to \$0.26 => Enron filed for bankruptcy. \$ 60 billion lost. 20.000 employees lost their jobs and their savings

2002: Collapse of accounting firm Arthur Andersen LLP due to involvement in Enron scandal

Arthur Andersen provided both auditing and consulting => conflict of interest

2006: convictions of Kenneth Lay, Jeffery Skilling, Andy Fastow and other managers

Enron 4/6

Consequence: Sarbanes –Oxley Act from 2002 (SOX)

Also known as: “Public Company Accounting Reform and Investor Protection Act”

Code of corporate governance making management responsible for audit. Incorrect financial report is a criminal offence.

Financial reports must certify that the statements truthfully represent the company’s financial health, no untrue statements or mis-leading omissions

Auditors should be independent => no conflicts of interest

Auditor rotation

Enron 5/6

Dilemma of management:

CFO Andy Fastow served a six year sentence:

2019 speech:

“Every single deal I did as I was CFO of Enron was approved by Enron’s accountants, the outside auditors of Arthur Andersen, Enron’s attorneys, Enron’s outside attorneys, the bank’s attorneys and Enron’s board of directors.” (<https://ucalgary.ca/news/former-enron-cfo-accounting-hero-convict#>)

Dilemma due to obligation of management towards the shareholders: Use the full legal framework for the benefit of the corporation and at the same time be sensitive towards potentially criminal constructions

Enron 6/6: Ethical aspect

Principles of Sarbanes-Oxley act are principles which ought to be taken for granted

Cases like Enron demonstrate

- 1) Business person under pressure => make use of the entire legal spectrum, every act which is not forbidden will be perceived as legal
- 2) Temptations to make money can weaken ethical sensitivity

British businessman Sanjay Shah involved in cum-ex, a dividend tax fraud scheme

- € 2 billion of Danish tax payers money lost
- Logic: Possible and not explicitly illegal, therefore morally justified



Definitions, concepts and risk mitigation

Definitions Corporate Governance

The system by which companies are directed and controlled => setting the goals and controlling the implementation of these goals. (Cadbury Report 1992)

System of rules, practices and processes by which a firm is directed and controlled (Investopedia.com)

A **set of relationships** between the companies management, its board of directors, its shareholders and other stakeholders which **provides the structure** through which the objectives of a company are set, and the means of **attaining** these objectives and **monitoring** performance. It helps to define the way **authority is allocated** and the way corporate decisions are arrived at and executed. (www.lawinsider.com)

Central Concepts

Code of corporate governance: Recommendations on how to govern a corporation in accordance with general standards

Compliance: Acting in coherence with legislation

Corporate Integrity: Shared corporate values as foundation for strong compliance culture

Integrity / compliance management: Practical challenges of ensuring law abiding culture in corporations

Corporate Governance as solution to issue

Issue: Separation of ownership and control in publicly listed companies

Mature listed corporations: professional management versus a more or less anonymous group of shareholders/investors

Principal-Agent problem: One party (the agent/management) agrees to work in favour of another party (the principal/shareholders) => challenges of incentivising agent

Owners do not control the company, therefore incentive structures of management need to be aligned with interests of shareholders

Risks of bad corporate governance

- 1) Reduced profitability
- 2) Reputational risks
- 3) Heavy fines and imprisonment
- 4) Loss of public contracts

1) Profitability risk

Good corporate governance organises management processes **systematic** communication

Increases **efficiency**, checks and balances and clear distribution of **responsibilities**

Systematic communication, transparent lines of command and transparent distribution of responsibility **mitigates the risk of mistakes** being made or mistakes remaining undiscovered

Lower risk of informal power structures

Informal power structures can decrease profitability because personal ambitions collide with the need for transparency

2) Reputational Risk

Incompliance makes firms vulnerable to public criticism

Internet, social media and NGOs (e.g. Greenpeace)

Loss of control over company's communication in mass media where perception is reality

Strong public focus on corporate misconduct and general distrust of elites, in particular of managerial elites

Requires monitoring of online activities

(Lütge and Uhl p. 247)

2) Reputational risk

Risk depends on line of business =>

Known brands like VW, H&M and Zara are sensitive to reputation because consumers have many alternatives. This increases the risk of consumer boycotts

Amazon, well known with high exposure to consumers, but low willingness to use alternatives makes them less sensitive to reputational risks

Anonymous corporations who move beneath the radar of public attention => lower risk

2) Reputational Risks

Difficulties attracting talent

Reduced employee motivation, shame of working for the company

Less attractive for investments

=> Example: Large asset managers are required to refrain from investing in non-compliant corporations

Example of reputational damage:

4th of August 1991 article in the German magazine “Der Spiegel”:
“The Death From Ingelheim”

Claim of Spiegel article: The German company Boehringer Ingelheim contributed to production of a chemical called “Agent Orange”. It was used by the Americans in the Vietnam War (1955-1975) to make the trees in the jungle lose all their leaves

Agent Orange made it impossible for the communist enemy (Vietcong) to hide. Agent Orange is known to be carcinogenic (causing cancer) and to cause birth defects. According to Vietnam authorities four million Vietnamese have been affected

19 November 2019

A medical professor by the name of Fritz von Weizsäcker gave a speech in Berlin. By the end of the speech he was attacked by a man with a knife and killed.

Reason for the murder: Fritz von Weizsäcker was the son of the former German Bundespräsident (1984-1994) Richard von Weizsäcker (1920-2015)

From 1962 – 1966 Richard von Weizsäcker was on the management board of Boehringer Ingelheim

The murderer wanted to revenge the four million Vietnamese victims of Agent Orange, and since the father had died, he killed one of his sons

Reputational risk: Homepage 2023 (32 years later)



Boehringer
Ingelheim

About Us ▾

Human Health ▾

Animal Health ▾

Science & Innovation ▾

Partnering ▾

Careers

**Boehringer Ingelheim did not
produce Agent Orange. The
company did also not contribute
to its production by supplying
precursors or raw materials.**



3) Heavy fines and imprisonment

Incompliance with codified law (Anti-corruption law, competition law, data protection law etc.)

Heavy fines which skim off the economic advantage of the company arising from the unlawful act

Management accepting violations committed by employees => liability

Criminal prosecution up to 10 years imprisonment

Enron: Jeffrey Skilling sentenced to 24 years in prison, released after 20 years

Siemens: Fines € 1,6 Billion

Lorry cartel in Europe from 1997 – 2010: € 3 billion

4) Loss of public contracts: Public Procurement Law

Companies need to be law-abiding and trustworthy to be considered for public procurement procedure (especially in construction and defence industry)

Conviction and fines paid by companies are publicly available in the commercial central register

If companies are exempted from public procurement, it can end up in **a vicious circle** (especially if competitors become more active)

The re-approval process of companies requires **comprehensible confidence-building measures**

Case example: Wirecard scandal

German Dax corporation insolvent in 2019 due to fraudulent financial reporting

Accounting firm EY responsible for audits

Failed to double check the bank statements =>

Failed to contact the banks and get an independent confirmation, that the information provided by Wirecard for the financial audit was correct.

Wirecard 1/7

Payment service: Connecting the customer in the shop and in e-commerce and shops

Founded in 1999. In 2001 after the dot com bubble, - almost bankrupt.

2001 Markus Braun joined => offered payment services to dubious websites.

2006 Listed on the TecDAX, index of 30 largest companies of technology sector

From 2007: International expansion

2015 Financial Times: “House of Wirecard” –series begins. Journalist Dan McCrum claiming there is something wrong with Wirecard

September 2018: Wirecard listed on the DAX

DAX = An Index of the largest and most profitable publicly listed corporations in Germany

Wirecard 2/7

2018 Whistle blower from Wirecard (Singapore) contacted Dan McCrum from Financial Times who had written about Wirecard in 2016, and told him, he was right ..

30th of January 2019: Financial Times article claiming that contracts were forged.

16 November 2019: Wirecard defends themselves: FT is wrong, and Wirecard is a solid business with 300.000 customers

Wirecard claimed, that the FT journalists has leaked the story to hedge funds in advance so that they could speculate (short sell) against Wirecard

Wirecard 3/7

Wirecard's claim:

Wirecard can connect credit cards of customers with their bank world wide.

In Germany they can act as intermediary bank, but they do not have banking licences abroad, for which reason they need local partners.

Local companies offer Wirecard payment service against a fee.

The fee is paid to an escrow account (intermediate account), and kept there as a guarantee in case there is not enough money on the bank account of the individual customers

=> Wirecard has an account with €1,9 billion

Wirecard 4/7

October 2019: Wirecard forced to call for and independent audit by KPMG.

KPMG: Wirecard did not provide sufficient information, therefore the report is inconclusive

Wirecard: You see, we have done nothing wrong. And we will improve the documentation.

April 2020 EY – the official auditor of Wirecard refused to sign the audit.

The auditor cannot confirm, that the numbers that Wirecard have provided are also correct.

June 2020: According to EY, the 1,9 Billion Euro which according to Wirecard was placed on fiduciary accounts (but the money belonged to Wirecard, as long as the partner companies did not need to make use of the guarantee) Turn out to be non-existent

€ 20 billion lost

Wirecard 5/7

Exit plan (if they had succeeded): Operation Panther

Wirecard taking over Deutsche Bank

Covering up fraudulent business by merging the statements of Deutsche Bank with those of Wirecard

25th of June: Wirecard filed for Bankruptcy

CEO Markus Braun arrested

CFO Jan Marsalek escaped (believed to be in Moscow)

Court case in Munich from December 2022

Polizeipräsidium München

Betrug in Milliardenhöhe

Die Staatsanwaltschaft München I, das Polizeipräsidium München und das BKA bitten um Ihre Mithilfe!

Jan MARSALEK, Ex-Vorstandsmitglied der Wirecard AG, steht in dringendem Verdacht, sich des gewerbsmäßigen Bandenbetrugs in Milliardenhöhe, des besonders schweren Falls der Untreue und weiterer Vermögens- und Wirtschaftsstraftaten strafbar gemacht zu haben. Aktuell befindet er sich auf der Flucht.

2017 2018

Jan MARSALEK *15.03.1980

Können Sie Hinweise zum Aufenthaltsort von Jan MARSALEK geben?

Wir bitten Sie, Ihre Hinweise dem PP München unter **+49 (0) 89/2910-0** oder jeder anderen Polizeidienststelle mitzuteilen. Außerdem können Sie hierfür das Kontaktformular der Polizei Bayern unter www.polizei.bayern.de nutzen. Ihre Hinweise können vertraulich behandelt werden!

Pressegeheim und Vorlagen: PP München / August 2019

Wirecard 6/7

EY Failure

A company's auditor is obliged to ensure independent confirmation of bank statements

After having received the information from the client company X, the auditors contact the bank and asks if the bank can confirm that the statements provided by company X are correct

With Wirecard, EY did not take this precautionary step

Combination of disregard for principles of corporate governance and lack of auditor diligence

Wirecard 7/7: The Guardian 16.11.2020

EY

Call for three-year ban on EY bidding on public contracts

Anti-corruption group claims 'recurring professional misconduct' should preclude auditor from future business

Simon Goodley

Sun 15 Nov 2020
16.54 GMT



Sliding into fraudulent business

Fraud often starts out as a minor mis-representation for the purpose of buying time to compensate for low performance

Mis-representing high result increases expectation => requires an overcompensation in the following year.

Overcompensating concealed deficit and overcompensating for higher expectations

⇒ Success: minor mis-representation can be covered up. Lack of success => requires even higher level of mis-representation

⇒ Snowball effect



Codes of Corporate Governance

Deutsche Corporate Governance Kodex

Mixture of legislation and recommendations for corporations listed in the

Legislation (German code: “**Principles**”)

=> concerning persons or companies carrying out economic activities.

=> formal processes of boards of directors

Suggestions/ recommendations: according to the principle “**comply or explain**”

“Soft coercion”: Compliance with corporate governance rules necessary for being listed on stock exchanges

Legislation and recommendations

German code: **Principles** = legal requirements

Principle: **The Management Board is responsible for managing the enterprise in its own best interests.** (Have to)

Suggestions and recommendations are soft law (comply or explain)

Example:

Corporate planning shall include corresponding financial and sustainability-related objectives. (Comply or explain, if you do not comply)

Procedures

Germany: Three bodies:

Annual general meeting (Hauptversammlung)

Supervisory board (Aufsichtsrat)

Executive board / Management (Vorstand/Geschäftsführung)

Annual General Meeting

Meeting of shareholders, supervisory board and management.

Enables shareholders to exercise their membership rights

Management submits fiscal statement for all shareholders to read and informs shareholders about the company's performance and strategy

Shareholders can confront supervisory board and management with questions

Shareholders appoint or re-elect members of supervisory board

Supervisory Board

Shareholders own the corporation and they appoint the members of the supervisory board

Supervisory board are representatives of shareholders and representatives of employees if applicable (Larger corporations in Germany: 1/3 employee representatives in supervisory board)

It oversees the management on behalf of the shareholders

=> Agency problems: Members of supervisory board and managers may have interests which are not coherent with the interests of the shareholders or with the interests of other relevant stakeholders

Supervisory Board (German rules)

For corporations listed on the stock exchange: The supervisory board members meet at least twice a year (four meetings per year are also normal)

Private corporations (not listed): Supervisory board can decide to meet only once a year

Normally, the chairperson calls the meeting

Important documents should be handed over to members of the board in time for them to prepare for the meeting

Meeting has an agenda and decisions are made with regard to the points of the agenda

At least half of the board members and at least three members are required for the board to have a quorum – i.e. to be able to make decisions

Executive Board / Management (Vorstand)

Responsible for managing the company, for developing strategies in cooperation with the supervisory board and for the implementation

Accountable to the supervisory board

Responsible for organising and signing audits

Responsible for ensuring that employees comply with legal requirements

Other national codes of corporate governance:

UK Financial Reporting Council: The UK Corporate Governance Code
(Lütge and Uhl p. 198)

US Corporate Governance Code: Sarbanes-Oxley Act
(A Reaction to the scandals of Enron and Worldcom)

International corporate governance standards

G20/OECD Standards for Corporate Governance: Help nations improve legal and institutional framework for corporate governance

United Nations ISAR (International Standards of Accounting and Reporting) International benchmark for ...

- 1) Auditing,
- 2) Board and management structure and process,
- 3) Corporate responsibility and compliance,
- 4) Financial transparency and information disclosure, and
- 5) Ownership structure and exercise of control rights.

Management and supervisory board

National difference:

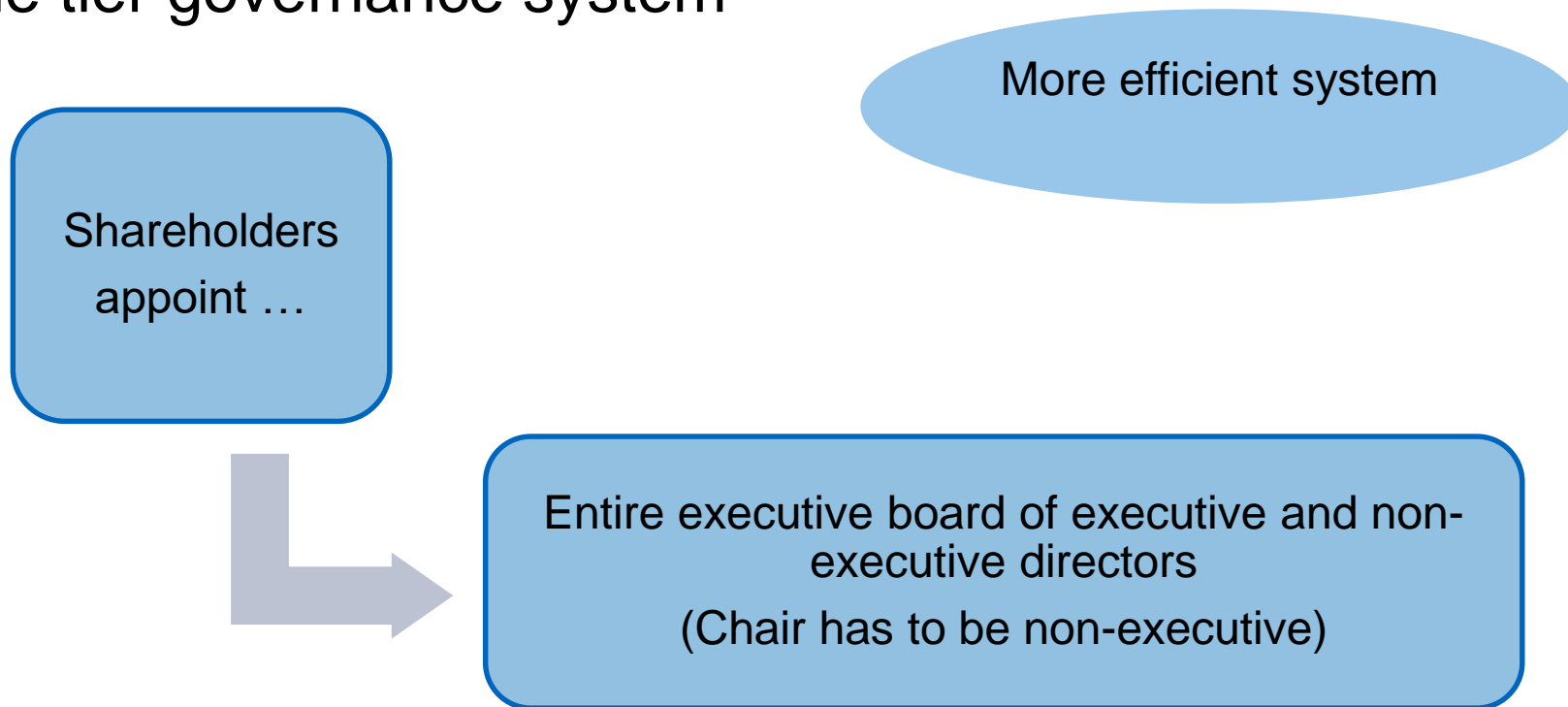
One-tier system:

- UK
- US
- South Korea
- Italy
- Malaysia
- AUS
- SA
- India

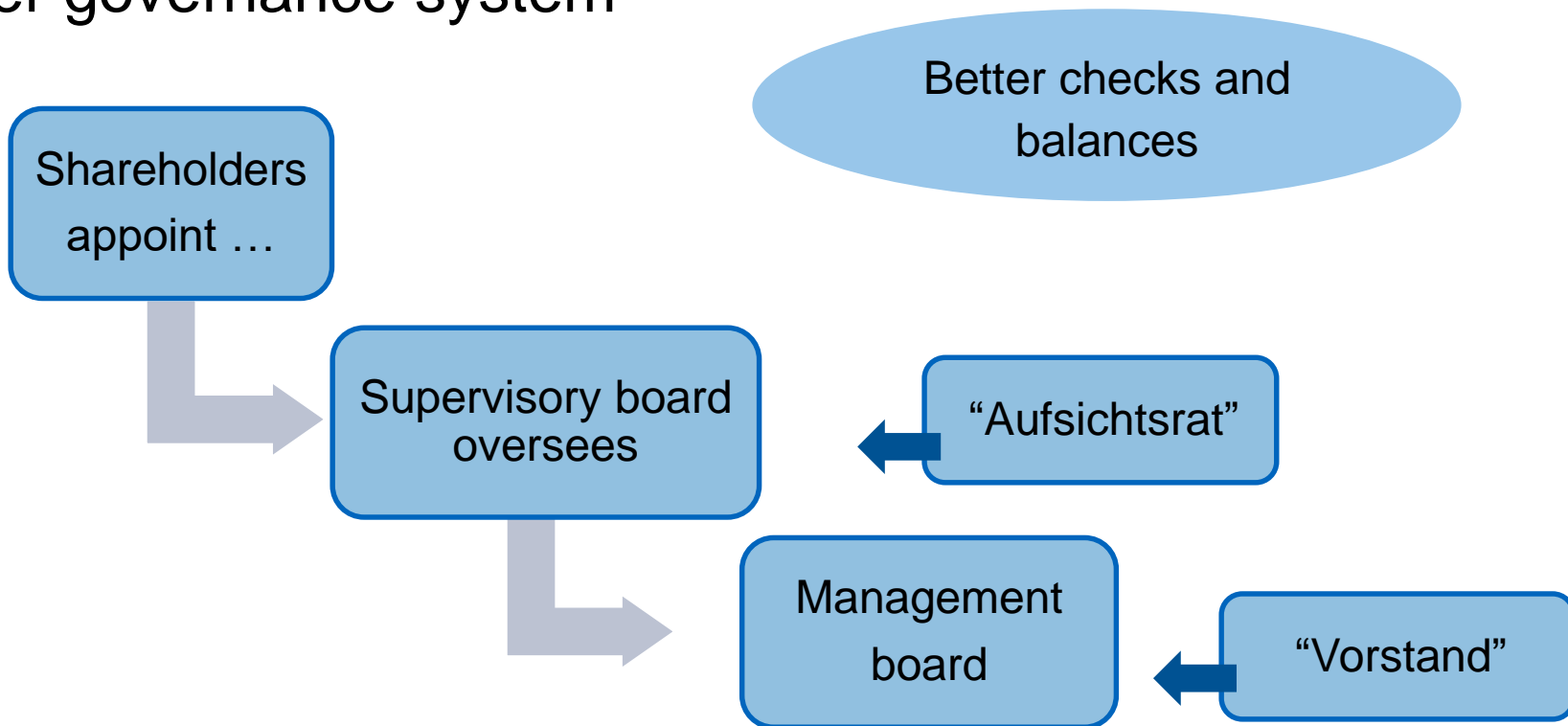
Two-tier system:

- Ger, Aut, NL, DK
(mandatory)
- CZ, PL, RU, HU
- China
- Japan
- Brazil

One tier governance system



Two tier governance system



Example from two-tier system

German Code of Corporate Governance (two tier)

“The Supervisory Board appoints and dismisses the members of the Management Board.

....it supervises and advises the Management Board in the management of the enterprise and has to be involved in decisions of fundamental importance to the enterprise.

UK Code of Corporate Governance (one tier)

“Non-executive directors have a prime role in appointing and removing executive directors.”

“Non-executive directors should scrutinise and hold to account the performance of management and individual executive directors against agreed performance objectives.”



Themes of Corporate Governance Codes

Conflicts of interests must be disclosed

Lack of board independence from management: Undermines the supervisory function of the board.

Ideally, close personal relations between management and supervisory board members should be avoided

- ⇒ Supervisory board members primarily support management and not the long term interests of the corporation.
- ⇒ Risk of mistakes made by management being ignored
- ⇒ Risk of disproportion between CEO salary (remuneration) and company performance

Insufficient dedication: Lack of independent insight into challenges and issues => uncritical approval of management

Conflicts of interest

Members of management and supervisory boards are not allowed to pursue their own business interests as members of the boards (Principle)

Example of conflict of interest: A supervisor board member has an economic interest in one of the company's suppliers. Supporting the supplier in relation to the company would manifest a conflict of interest

Side-line activities of management board members need to be approved by supervisory board (Recommendation)

Conflict of interest example

Cross board membership

Philippa Smith on
supervisory board
in firm X

Peter Brown on
supervisory board
in firm Y

Peter Brown on
management
board in firm X

Philippa Smith on
management
board in firm Y

Remuneration of the management board and supervisory board

Principle: Salaries and bonuses aligned with the corporations long term interest

Example: Bonuses tied to long term performance.

Dilemma:

Long term performance of a corporation: six years

Economic bonus to incentivise manager: On annual basis

Preventing Incompliance

Good corporate governance reduces the risk of incompliance

Corruption (Siemens case from 2006)

Cartels (Lorry cartel)

Abuse of data (Cambridge analytica)

Lütge and Uhl pp. 196 – 227

Integrity management: Code of Ethics

Well governed companies => compliance or integrity management system

Purpose:

Inform members of the organisation are informed about rules and regulations

Make members confirm (i.e. sign) that they have received this information

=> Determine liability in case of misconduct

Challenge: Prevent information overload => IT based compliance management systems providing employees with relevant information at the right time

Example: Booking of a flight ticket to high risk nation => the employee receives relevant information and is required to confirm (tick box) that this information is received and understood

Integrity management

Coherence with culture

Balance between merit based competitive culture and openness and forgiveness regarding mistakes

Extremely competitive culture leads to a cover-up-mistakes culture and increases the risk of mis-conduct

Recent development: Due diligence of business partners and screening of suppliers

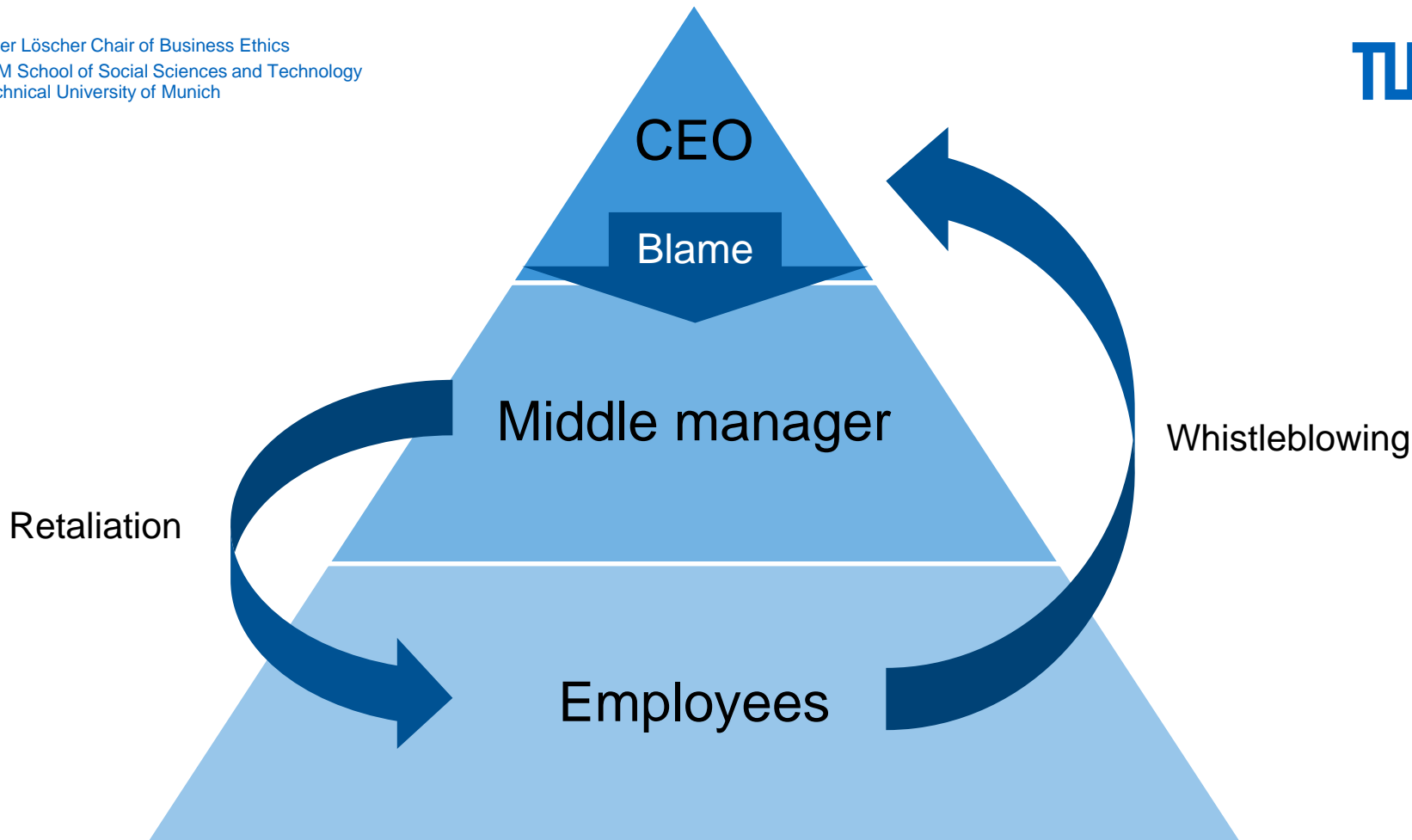
2023: EU supply chain law

Whistle-blower system

Whistle-blower: Person who informs management or board of directors of misconduct in the organisation.

Risk: Telling on colleagues => perceived as an act of disloyalty => Whistle-blower provides information which can ruin careers and – in case of criminal action – lead to imprisonment.

Whistle-blower system give employees a place where they report anonymously on compliance breach and/or illegal behaviour without risking retaliation from colleagues



Whistle-blower system legislation

Whistle-blower system required for companies with more than 250 employees

Main purpose: Avoid corruption: Estimated that that corruption adds 15% to the costs of publicly funded projects in EU

Whistle-blower system provides a procedure which clarifies

- 1) Whom to report to – the responsible person(s) must react within three months.
- 2) How to ensure confidentiality
- 3) That whistle-blowers cannot be punished for breaking contracts or confidentiality agreements if they believe they are reporting the truth
- 4) That they are informed of their rights to legal aid

(Lütge and Uhl p. 218)

Channels for Whistleblowing

Post-box: Requires that a person can report without being seen

E-Mail: Reporter might want to use anonymous e-mail address

Ombudsperson: An independent person who can receive reports (can be expensive)

Digital whistle-blower system: Anonymous communication between whistle-blower and receivers of the reporting

Example of software solution to anonymity



The leading Pan-European marketplace, representing a **€7 trillion market capitalisation**.
European stock exchange seated in **Amsterdam, Brussels, London, Lisbon, Milan, Oslo and Paris**.



Euronext Corporate Services helps companies make the most effective use of capital markets



Whistle-blower can create
anonymous profile, identify
case topic, time, date, location,
persons involved.

The whistle-blower will receive
feedback regarding the development
of the case



Identification
Subject
Case
Review

Case Topic

- ☐ Corruption or trading influence ⓘ
- ☐ Human Rights ⓘ
- ☐ Threat or injury for public interests ⓘ
- ☐ Antitrust / Competition Law ⓘ
- ☐ Anti-Money Laundering and Combating the Financing of Terrorism ⓘ
- ☐ Other crime or criminal offence ⓘ
- ☐ Racism / Discrimination ⓘ
- ☐ Sexual harassment ⓘ
- ☐ Denial of benefits ⓘ
- ☐ Intimidation ⓘ
- ☐ Termination / Layoff ⓘ
- ☐ Conflict of interest ⓘ
- ☐ Financial fraud ⓘ
- ☐ Gifts and bribery ⓘ
- ☐ Inside information breach ⓘ
- ☐ Security breach ⓘ
- ☐ Safety and Health ⓘ
- ☐ Other

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