SUMMER/FALL 2012

# management ethics

IN THIS ISSUE



ethicscentre.ca
Canadian Centre for Ethics & Corporate Policy

# Report of the Chair

BY G. (GEORGES) DESSAULLES

It has been my privilege to serve as Chair of the Ethics Centre (the Centre) since the last annual meeting in May of 2011. With this report, I am pleased to update members on what has been accomplished by the Centre through the efforts of its directors, staff and volunteers since then.

This was the second year for the Graduate Research Scholarship established by the Centre. We received applications from 19 graduate students – 17 in Doctoral programs and 2 in Masters programs. Most candidates are pursuing advanced degrees in business with a few pursuing careers in health science, law or political science.

A committee, chaired by Robert Timberg, which included directors of the Centre as well as an external reviewer, adjudicated the applications and awarded the scholarship to Ms. Nazila Assasi, a doctoral student in health research methodology at McMaster University. She has a Doctor in Medicine (MD) from the University of Tabriz in Tabriz, Iran, a Master's in Public Health from Tehran University of Medical Sciences in Tehran, and a PhD in Epidemiology also from Tehran University of Medical Sciences. Her topic is "addressing ethical and moral issues in health technology assessment: development of a practical framework".

With the upcoming challenges facing Canada in the area of health care and the management of scarce resources, the topic seemed to be very appropriate and timely. A cheque for half of the award monies was presented to Dr. Assasi at the March 6 luncheon which featured David Olive, a well-known columnist with the Toronto Star. The balance will be awarded after the project is completed and her report has been submitted to the Centre. At that time, the Events Committee may wish to invite Dr. Assasi to speak about the project and her conclusions to members at a breakfast or luncheon event. The scholarship program will be continued for another year with a fall 2012 application deadline. We expect to continue to attract the same high quality applications as we have done in the past.

The Strategic Task Force under the leadership of Derek Hayes has become a permanent committee of the board in view of the importance of its mandate and the continuing need for the Centre to search for new and better ways to accomplish its mission and improve its offerings to members and, at the same time, remain relevant in today's fast-paced and ever-changing business environment. It is staffed by a highly committed group of directors and has met several times in the fall of 2011 and winter of 2012. Several new initiatives are currently being considered and will be announced through the Centre's website once they have been approved by the board.

Under the leadership of Blair Peberdy, the Communications and Member Services Committee was successful in relaunching the Centre's website in the summer/fall of 2011. We invite members to access the website of which we are justifiably proud and to use its contents. We are striving to constantly improve the content of the site; it includes summaries of the breakfast and lunch events and, soon, we hope to have some exciting news about additional interesting offerings for members.

During the summer of 2011, the Communications and Member Services Committee decided that it was time to reconsider how the Newsletter was being published. A decision was made to suspend publication in favour of publishing articles on the website as they become available. A series of articles on the topic of securities regulation and ethics is now available. The committee believes this will make the Centre more relevant to members and the public at large by ensuring the content is more easily and promptly accessible. In the fall of 2011, Hentie Dirker agreed to assume the chairmanship of the Communications and Member Services Committee with Blair remaining as head of the Newsletter Committee. Since then, the committee has made the Centre accessible through Twitter and LinkedIn in the hope of using social media to increase the Centre's reach. On behalf of the Board of Directors, I am pleased to extend sincere thanks to Blair and Hentie, to the Newsletter Committee and its members, to Andy Strote at Context Creative for their donation of layout and graphic design, and to our colleagues at the Canadian Institute of Chartered Accountants for their ongoing contribution to the Centre by printing the Newsletter on a *pro bono* basis.

We are grateful to our treasurer, Vince Power, for the preparation of realistic annual budgets and his detailed reports to the Executive Committee and the Board of Directors on revenues and expenses. Special thanks to our long-time bookkeeper Kathleen Courey who decided to retire this year in order to spend more time with family. We wish her much happiness in this next phase of her life. We also extend a warm welcome to our new bookkeeper Peter Hansen who assumed the role in the fall of 2011.

Over the past year, the Centre has continued to have both the luncheon and breakfast events in order to serve our members and for the wider business community. We have had a very successful series of luncheon events featuring the President of Imperial Oil – Bruce March, David Olive of the Toronto Star, Jim Stanford, Economist with the CAW and a frequent guest on CBC's The National, Patrick McGrade, Vice-President, Corporate and Legal Affairs and Corporate Secretary of GlaxoSmithKline Inc. and Jean Augustine, Fairness Commissioner of Ontario.

"WE ARE STRIVING TO CONSTANTLY IMPROVE THE CONTENT OF THE SITE; IT INCLUDES SUMMARIES OF THE BREAKFAST AND LUNCH EVENTS AND, SOON, WE HOPE TO HAVE SOME EXCITING NEWS ABOUT ADDITIONAL INTERESTING OFFERINGS FOR MEMBERS.

We also hosted our first webinar in conjunction with David Nitkin of EthicsScan Canada which was sold out. Our breakfast events continue to attract a group of dedicated specialists and practitioners, and to foster interactive discussion and more in-depth reviews of current ethics topics. One breakfast event covered how a large financial institution established policies and procedures to guide its employees about issues related to the use of social networks in the workplace. Another addressed how to create and implement a successful compliance program. I congratulate the Events Committee chaired by Joan Grass for its excellent work over the last year. As part of its mission to further the consideration of ethics issues in decision-making, the Centre sponsors students from various universities and colleges to attend its luncheon and breakfast events and we are pleased to report that we have had up to 10 students at one of the events.

A small working group of directors has undertaken a review of the Centre's corporate governance practices under the leadership of Robert Timberg. We have been fortunate to benefit from pro bono legal advice from McCarthy Tetrault for this project. The goal of the review is to ensure the Centre meets best practice standards for not-for-profit organizations of a similar size and budget. A special thanks to Rob and his working group for their efforts on this project which I consider to be of great importance for the Centre and its Board of Directors and members. The working group expects to complete its work by the end of the 2012 calendar year.

It has been an honor to serve the members of the Ethics Centre as your chair and to work with an excellent Board of Directors. In particular, I am grateful for my colleagues on the executive committee; my predecessor Mimi Marrocco who, as past chair, has shared her wisdom and experience, Vince Power, whose financial expertise and knowledge of the financial affairs of the Centre is crucial to its operation and all the committee chairs, who are so important to the ongoing development of the Centre.

I would also like to acknowledge the contribution made by the many volunteers who have contributed their time and knowledge to the affairs of the Centre. I would also like to specifically acknowledge Chris Montague, who, unfortunately, will be leaving the board this year; he has provided wise counsel and opened many doors for the Centre both as a member of the board and of its Nominating and Governance Committee. We hope that he will continue his association with the Centre as he gradually moves into the next phase of his life.

Last, but certainly not least, I thank our administrator, Lois Marsh, and our Executive Director, Hélène Yaremko – Jarvis for their dedication, their energy and enthusiasm that underlies the ongoing support of the Centre and its mission. It is thanks to their tenacity and organization that the Centre is able to sustain its membership, attract new members and offer quality programs and publications.

# Ethical Responsibilities of Securities Lawyers

BY EDWARD WAITZER

Senior Partner, Stikeman Elliott LLP

The world of transactional lawyering has changed dramatically, even in the course of my professional career. The advent of junk bond financing in the mid-80s destabilized traditional corporate/law firm relationships, leading to more of a focus on retaining individual lawyers for particular transactional work. Likewise, advances in communications technology and the globalization of markets lead to the growth of larger national (or global) law firms. The advent of substantial in-house law departments (in a real sense, internal law firms) has tended to position inside counsel as the "trusted advisor", often relegating outside law firms to more of a managed commercial service provider role, competing to deliver increasingly commoditized services. Deregulation of major sectors of our economies (e.g., telecom, finance, transportation, energy) has also tended to promote the view of outside lawyers as "zealous advocates" charged with the aggressive and efficient execution of transactions. Each of these dynamics has shifted the focus of transactional lawyers on duties owed to the client rather than to the "public" (other than refraining from facilitating the violation of law or lying on behalf of clients).

All of this has occurred in the context of market forces which have driven corporate (and public sector) clients (and the decision makers within such organizations) to ever shorter term incentives and behaviour. While one's client may be the corporation, relationships are developed with and instructions received from its senior agents, who generally have an even shorter time horizon than the organization itself.

Moreover, heightened liability concerns have driven corporate decision-makers to increased reliance on outside counsel. This reflects the fact that liability can often be mitigated by good faith reliance on "expert " advice. Hence it is that the very "agency conflicts" that inform corporate law (i.e., ensuring that management or controlling shareholders behaviour is consistent with the interests of shareholders and other stakeholders) has spawned a new set of concerns relating to third-party agents (who owe no duties, beyond their professional standards of conduct, to the corporation), including corporate counsel.

"PERHAPS THE TIME HAS COME FOR THE LAW SOCIETY TO OFFER MORE PRO-ACTIVE GUIDANCE ON THIS ISSUE – INDICATING THAT LAWYERS SHOULD (IN APPROPRIATE CIRCUMSTANCES) SEEK TO GUIDE THEIR CLIENTS AS TO RESPONSIBLE CONDUCT.

The risk, of course, is that in a world of short-termism and zealous advocacy it is all too easy to lose sight of the fact that our major institutions function as much on trust as on strict legal compliance. It is striking how public distrust in corporate conduct has escalated in the face of enormous investments made to better regulate governance practices through mandated structures and processes. Trust is a valuable asset that emerges from shared norms and fair dealing, based on current and past practices and an expectation of future behaviour. The erosion of such trust will, over the long term, significantly impair any enterprise's value.

This risk falls heavily on transactional lawyers because of the critical structuring and execution roles they often play. A consequence is that lawyers (and the opinions they provide) are often subject to "hindsight bias" – being judged after the fact, with a critical eye, when the focus is on assigning blame. For this reason alone lawyers should be mindful of changing norms and the broader context within which their advice is being relied upon.

The Law Society of Upper Canada specifically addresses these concerns in its Rules of Professional Conduct. Rule 2 (Relationship to Clients) notes that, notwithstanding that instructions may be received from a representative, when a lawyer is employed or retained by an organization (including a corporation), the lawyer's duty is to the organization. This includes an obligation to report "up-the-ladder" and/or withdraw from acting once a lawyer believes that the organization intends to act in a wrongful manner. The commentary to Rule 2 recognizes that:

"Lawyers acting for organizations are often in a position to advise the executive officers of the organization not only about the technicalities of the law but about the public relations and public policy concerns that motivated the government or regulator to enact the law. Moreover, lawyers for organizations … **may** guide organizations to act in ways that are legal, ethical, reputable, and consistent with the organization's responsibilities to its constituents and to the public." [emphasis added]

Perhaps the time has come for the Law Society to offer more pro-active guidance on this issue – indicating that lawyers should (in appropriate circumstances) seek to guide their clients as to responsible conduct.
Equally importantly, in a world where public expectations and legal norms are evolving rapidly, corporate boards should recognize their particular need for dispassionate and independent legal counsel. In seeking such advice, they should be satisfying themselves that counsel acknowledge such professional obligations and carefully consider any incentive that might lead to counsel's judgment being compromised. Directors should be aggressively supporting a restoration of the balance between zealous advocacy and the exercise of independent judgment by their counsel concerning the underlying meaning and purpose of the law.

So, too, should be the leading law firms. It goes to the heart of what we should want to be.

**EDWARD WAITZER** is a senior partner of Stikeman Elliott LLP, a professor and Director of the Hennick Centre for Business and Law at York University and a former Chair of the Ontario Securities Commission.

# (Behavioral) Ethics in Securities Regulation: A View from the U.S.

BY ROBERT A. PRENTICE

McCombs School of Business, University of Texas at Austin

Ethical guidelines allow people to live together in groups. Robinson Crusoe living alone on an island has no need for ethics, at least until Friday shows up. But when humans live together, ethics are helpful and indeed necessary for them to live in harmony. Even if they are Sisters in a religious order.

And finance professionals are not Sisters. There is evidence that people of easy virtue often self-select into financial careers, that finance professionals find the ethical issues implicated by such actions as insider trading to be less salient than do others, and that stock market traders are more reckless and manipulative than psychopaths from local prisons. Therefore, few topics deserve attention more than the interplay of ethics and securities regulation. Recent research has some in the U.S. rethinking the interrelationship between ethical behavior and disclosure requirements in the securities industry. Mandatory disclosure is often used as a default response by regulators. In Justice Brandeis's words, sunlight is the best disinfectant and electric light the best policeman. Disclosure is consistent with free market principles and with the rational man economic model and its assumption that well-informed consumers will make wise choices that protect their interests. Plus, disclosure has the advantage for legislatures and regulators of constituting a significant symbolic action, yet one that is relatively easy to promulgate (in that it will not receive nearly as much industry push-back as substantive regulation), and not particularly resource-intensive. The allure of disclosure also stems from the presumption that when exposed to daylight via disclosure, securities industry actors will be on their best ethical behavior. Unfortunately, recent research indicates that disclosure does not always work as well as theorized, either to help investors protect themselves or to encourage financial professionals to mind their p's and q's.

"UNFORTUNATELY, RECENT RESEARCH INDICATES THAT DISCLOSURE DOES NOT ALWAYS WORK AS WELL AS THEORIZED, EITHER TO HELP INVESTORS PROTECT THEMSELVES OR TO ENCOURAGE FINANCIAL PROFESSIONALS TO MIND THEIR P'S AND Q'S."

Consider officers' pay. In the U.S., officer pay in large companies skyrocketed from 140 times that of the average employee in 1991 to around 500 times that of the average employee in 2003. The U.S. Securities Exchange Commission (SEC) has pursued the theory that more timely and detailed disclosure of officer pay provides a restraining influence upon the rise in such pay by outraging shareholders and embarrassing the recipients. Unfortunately, the result has been the opposite. Shareholder power in public corporations is typically insufficient to channel their outrage effectively. And when officers learn that anyone makes more than they do, they tend to believe that they should earn more than their current pay, not less. Psychological research indicates that most people believe that they are more competent than their peers, as well as more ethical. Most of us believe ourselves to be ethical, competent, and deserving. We tend to attribute our successes to our merit and our failures to bad luck. Those at the top of the corporate pyramid, even more than others, often manifest extreme hubris. Thus, disclosure alone tends to increase rather than decrease the trend toward overcompensation of corporate officers. It leads to a ratcheting effect whereby CEOs paid under the median disclosed compensation tend to receive above average raises. With continued disclosure but no substantive restraint, below-median CEOs tend to press more successfully for larger pay raises.

Consider stock brokers. When Congress enacted the Dodd-Frank Act in 2009 in response to manifold problems disclosed by the subprime mess and credit crunch, it asked the SEC to study, among many other issues, whether to impose a fiduciary duty upon stock brokers. This would be a meaningful substantive requirement. Currently, U.S. stock brokers owe a duty of suitability to their customers, meaning that they should recommend only securities that are suitable for their customers' investment purposes. However, if among a range of suitable investment products one would be the worst for the customer but provide the highest compensation for the broker, the broker may legally recommend that one. Imposition of a fiduciary duty would require the broker to recommend, among a range of suitable products, the one that would be best for the customer.

Brokers prefer, however, that they be required merely to disclose to their customers that they do not owe them a fiduciary duty. As noted earlier, the disclosure model of investor protection is based upon the assumption that investors are rational actors who know their own preferences and, if given adequate information, will make rational decisions to advance those preferences. However, Herbert Simon won a Nobel Prize in economics for demonstrating that people are rational, but only boundedly so. Indeed, over the past twenty years researchers in the new field of behavioral finance have demonstrated investors are systematically irrational in various important ways. Substantial psychological research indicates that most investors do not seek out all relevant information, do not read the information that they are exposed to, and often do not understand the information that they do read. Professors Omri Ben-Shahar and Carl Schneider recently studied in depth a wide range of disclosure requirements in the financial field and elsewhere. They concluded that "mandated disclosure is fundamentally misconceived because its solution to the problem of choice is information alone. But people's problems choosing go well beyond ignorance."

More significantly, recent research indicates that the psychological phenomenon of moral equilibrium can undermine the effectiveness of disclosure in this setting. Most people view themselves as ethical actors and keep a sort of moral scoreboard in their heads. When they fail to live up to their own standards, they feel a need to do something to make up for that failing in order to keep their moral bank account in equilibrium. This is called moral compensation. On the other hand, when they make a deposit in their mental bank account by doing something ethical, they may unconsciously give themselves permission to depart from their own standards because their mental account seems to be in pretty good shape. This is called moral licensing.

Recent experiments by Daylian Cain of the Yale School of Management and his colleagues indicate that if people in the position of stock brokers give advice to people in the position of customers when their interests do not align and are required to disclose the conflict of interest, they feel so good about themselves for having disclosed the conflict that they then give themselves moral license to give less objective advice to the customers. As a result, the customers end up worse off than if the brokers had not been required to disclose the conflict.

"MOST PEOPLE VIEW THEMSELVES AS ETHICAL ACTORS AND KEEP A SORT OF MORAL SCOREBOARD IN THEIR HEADS. WHEN THEY FAIL TO LIVE UP TO THEIR OWN STANDARDS, THEY FEEL A NEED TO DO SOMETHING TO MAKE UP FOR THAT FAILING IN ORDER TO KEEP THEIR MORAL BANK ACCOUNT IN EQUILIBRIUM."

In a series of experiments, Cain and colleagues found that when a conflict of interest was disclosed by an advisor, the advisee tended to trust the advice given less, but to accept it more. In one experiment, "choosers" were given a choice of two options. B was pretty obviously inferior to A. When the advisors' and the choosers' interests were aligned, the advisors almost always recommended choice A and the choosers selected that superior option 93% of the time. However, in another iteration of the experiment, the advisors' interests were served by the choosers' selecting option B. In other words, the advisors profited by recommending the inferior option. Unsurprisingly, the advisors tended to recommend the inferior choice and choosers selected it 42% of the time when the conflict was not disclosed. When the same conflict existed and the conflict of interest was disclosed to the chooser, the advisors tended to recommend the inferior choice even more often and the choosers selected it 76% of the time. In other words, when they disclosed the conflict of interest, the advisors were not embarrassed into giving more accurate advice. Rather, they patted themselves on the back for having the honesty to disclose their conflict of interest and then gave themselves moral license to provide even more biased advice than when they did not disclose the conflict. And the choosers, although they clearly trusted the advice even less, tended to follow it more. Why? The researchers suggest it is because to reject it would directly impugn the integrity of the advisor, which is something people hesitate to do in most cultures.

What would be the state of the investment world if, as some have advocated, insider trading were legalized, any restrictions would be imposed by firms themselves, and firms had only to disclose whether or not they allowed insider trading in their shares? Empirical evidence from cross-national studies indicates that investor trust in the markets would sink, that many who invest in securities today would stop playing the game, and that capital costs would rise. Similarly, simply allowing brokers to disclose that they do not owe investors a fiduciary duty and inviting investors to take their chances risks causing investors to pull out of the markets. Surveys show that many investors currently believe, mistakenly, that brokers do owe them a fiduciary duty. When they find out that is not the case, they may be less willing to play the game and financial markets may become less liquid.

None of this is to imply that disclosure plays no important role in the securities world. Disclosure of financial information to experts such as institutional investors and stock analysts whose trading and recommendations set the market prices for securities is of remarkable value. When backed by strong fraud enforcement, such disclosure encourages investment, helps stock markets develop and promotes economic growth. As a universal panacea for all problems in the securities world, however, mandatory disclosure is overrated and should be rethought. Mandating disclosure is an easy out for regulators, but substantive regulation backed by vigorous enforcement often produces much better investor protection and therefore more efficient and liquid markets. Investment advisers already owe a fiduciary standard to their customers. Requiring that brokers also meet that standard makes good sense.

**ROBERT A. PRENTICE**
McCombs School of Business,
University of Texas at Austin

# Financial Misreporting in the C-Suite: A Case of Hubris?

BY MICHEL MAGNAN, Ph.D., FCA, ASC, C.Dir.

Professor and Lawrence Bloomberg Chair
John Molson School of Business, Concordia University

## TWO CASES OF FINANCIAL MISREPORTING STARS

How might we describe an entrepreneur who, in rapid succession, received the following public honours?

- Entrepreneur of the year
- Outstanding Achievement Award winner from Hollywood
- Honorary university doctorate
- One of the top 50 most powerful persons in an industry
- Appointment as director of one of the country's largest publicly held entities

We likely assume this person is neither shy nor interested in hiding from the limelight! Micheline Charest, the recipient of these honours, was founder, controlling shareholder and co-CEO of CINAR, a firm that became the target of endless allegations based on its use of tax credits, its financial reporting, its use of investment tax havens, and copyright infringement. Ms. Charest died in 2004 but some court cases from her days as Co-CEO (pre-2001) still linger. Financial improprieties, including earnings overstatements and improperly handled related party transactions, led to the firm restructuring and eventually it was sold at a significant loss to shareholders. Until accused of financial and business misconduct, Ms. Charest had a very public profile. Further, instead of undermining her rise to fame, the financial press, business circles and financial analysts, painted glowing profiles of her firm's operations, allowing the firm to raise significant amounts of new capital.

Is Ms. Charest's story unusual when we consider the list of executives charged with financial reporting frauds or improprieties? Consider another Canadian entrepreneur whose "products" achieved world-class status and whose achievements earned him the Order of Canada, who won several industry awards and who lived a very public life, highlighted in newspapers' society pages? The rise to fame of Garth Drabinsky and of Livent Inc. was also followed by a precipitous fall. Mr. Drabinsky avoided prison for many years through a trial that lasted an eternity but he is now a convicted felon. Livent itself went bankrupt soon after allegations of financial reporting fraud surfaced, some 14 years ago. As with Ms. Charest, it appears that Mr. Drabinsky's magic mesmerized bankers, investment bankers, accountants, journalists, analysts and investors enabling him to raise significant amounts of money despite a business model that was devouring cash at a fast pace.

What do Ms. Charest and Mr. Drabinsky have in common? On the basis of analyses performed with my coauthors Denis Cormier (UQAM) and Pascale Lapointe-Antunes (Brock), we argue that these two successful individuals were driven by hubris to engage in financial misreporting and to deepen their involvement when economic or market forces started to work against them. Perhaps more importantly, their hubris was fed by the response of external actors. I now elaborate further on our study and its findings.

> "FURTHER, INSTEAD OF UNDERMINING HER RISE TO FAME, THE FINANCIAL PRESS, BUSINESS CIRCLES AND FINANCIAL ANALYSTS, PAINTED GLOWING PROFILES OF HER FIRM'S OPERATIONS, ALLOWING THE FIRM TO RAISE SIGNIFICANT AMOUNTS OF NEW CAPITAL."

## MANAGERIAL HUBRIS AS THE DRIVER OF FINANCIAL FRAUD OR MANIPULATIONS

Managerial hubris can be defined as exaggerated pride or self-confidence often resulting in retribution (Merriam-Webster Online Dictionary; Hayward and Hambrick, 1997). Hubris derives from Greek mythology in which it was deemed to be man's fatal flaw. "*Those excessively confident, presumptuous, blindly ambitious or otherwise lacking humility were relentlessly struck down by the gods*" (Grimal, 1986, as reported in Hayward and Hambrick, 1997, p. 106).

In our study, we looked at sixteen (16) Canadian firms whose senior executives were accused of financial reporting or disclosure fraud and for which there were formal accusations of financial reporting fraud filed by securities regulators. For each at least an administrative fine or penalty was levied. The alleged improprieties took place between 1995 and 2009 and our sample included failed firms such as Cinar and Livent, as well as, Hollinger, Atlas Cold Storage, Mount Real, Semi-Tech, Bre-X and YBM Magnex. We matched these troubled firms with comparable counterparts that have not been subjected to allegations of misreporting or fraud and compared them in terms of financial results, governance and, most importantly, managerial hubris. Since we cannot observe or measure directly a CEO's or a senior executive's hubris, we relied on an indirect measure that comprises the following elements: awards, distinctions or prizes obtained by the CEO or other senior executives, favourable media coverage, favourable analyst coverage (market darling phenomenon) and the fact that the CEO is also the founder of the firm.

We argue that, fed by fawning praise from external parties, CEOs and executives at the failed firms developed an exaggerated self-worth and became immune to (or intolerant of) criticism, thus reinforcing their over-confidence. First, such expressions of praise or adulation by external observers raises an individual's conviction that he/she is right: if media coverage (or analysts) endorse with my views, I must be right. Second, the standing of an individual within his/her organization is also enhanced by such external praise: it becomes difficult to argue against someone who is on the front page of all financial newspapers and is the CEO, CFO, CIO etc. of the year. Finally, assuming that the executive has already started to engage in financial reporting manipulations or fraud, such expressions of praise or adulation by external observers, accompanied by his/her elevated sense of self-worth or arrogance, can translate into a challenge: if no one has noticed anything improper, this is an invitation to continue, especially if there are direct personal benefits to be derived from such actions.

## FINDINGS

Our findings show that firms that have been the object of financial reporting fraud allegations have the following distinguishing features:

- They typically have aggressive merger and acquisition strategies, which is consistent with evidence of managerial hubris. There is extensive research showing that hubris-driven CEOs are more likely, for example, to engage in takeovers that are not value-enhancing (e.g., Nortel);
- They have complex corporate structures, with several layers of holdings and affiliated companies, often in offshore centres (e.g., Semi-Tech or Hollinger);
- Their business model is often unique, i.e., they may be the only firm in Canada providing such services or products, thus impeding comparative analysis (e.g., Livent in live shows);
- Their CEOs and/or other senior executives have received numerous awards, prizes, distinctions or other forms of public recognition (e.g., honorary doctorates from universities);
- They have received favourable media profiles;
- They are market "darlings", managing successful initial public offerings or other public financings through reputable investment banks and receiving positive recommendations from stock market analysts;
- They still have their founder involved, either as CEO or executive chair.

Aggressive M&A strategies, complex corporate structures and unique business models are conducive to financial reporting manipulations as they put the firms' accounting systems under tension. However, they also contribute to hubris as they elevate executives' visibility within the media and financial markets. They also serve to further inflate hubris tendencies as they build up the ego of the executives on the receiving end of the praise. In contrast, our control sample firms did not exhibit the same features to the same extent. The differences were quite striking. Hence, we conclude that managerial hubris, as proxied by the attributes highlighted above, seems to be a consistent presence in firms subject to allegations of financial reporting fraud.

"WE ARGUE THAT, FED BY FAWNING PRAISE FROM EXTERNAL PARTIES, CEOS AND EXECUTIVES AT THE FAILED FIRMS DEVELOPED AN EXAGGERATED SELF-WORTH AND BECAME IMMUNE TO (OR INTOLERANT OF) CRITICISM, THUS REINFORCING THEIR OVER-CONFIDENCE."

## BUT, WHAT ABOUT GOVERNANCE?

Surprisingly, almost all failed firms in our sample possessed all the accepted visible signs of good governance such as an independent board, an audit committee, reputable auditors, prestigious investment bankers and even star directors. For instance, Livent's board was a who's who of Toronto's financial and legal elite. Hence, board-driven governance did not show itself to be a firewall against value-destructive actions by management. Thus, either the board and other players such as auditors and investment bankers involved were incompetent but in awe of the hubris-driven managers or, far more likely, they simply fully trusted these hubris-driven managers.

## LESSONS TO BE LEARNED

That CEOs and other senior executives are self-confident, and even somewhat arrogant, is often taken for granted. How would they otherwise attain such a high position? However, in his book *From Good to Great*, Jim Collins refers to his top achievers as being humble and modest: hence, we should probably revisit our priors as to the profiles of successful CEOs and executives. Moreover, assuming some degree of self-confidence is needed and useful to lead an organization, our findings suggest that there is a certain boundary which, if crossed, leads executives into hubris territory where their decisions and vision start diverging from common sense and become instead idiosyncratic if not random. The CEO (or other senior executives) is assumed to hold the truth, and it is self-evident. In such a context, directors, auditors or analysts should start questioning the quality and soundness of executive decision-making. Moreover, if a CEO or senior executive attracts and holds all spotlights upon him or her, hubristic tendencies are probably not far behind. These tendencies may reveal themselves in value-destroying M&A deals or new ventures but, also, in financial misreporting and irregularities. Checks and balances are always needed, especially if a firm and its senior management look as if they can do no wrong.


**MICHEL MAGNAN**

Professor and Lawrence Bloomberg Chair
John Molson School of Business, Concordia University



REFERENCES

Collins, J. 2001. From Good to Great. Harper-Collins: New York.

Grimal, P. 1986. *The Dictionary of Classical Mythology*. New York: Blackwell.

Hayward, M., Hambrick, D.C. 1997. Explaining the premiums paid for large acquisitions: evidence of CEO hubris. *Administrative Science Quarterly* 42, 103-127.

Magnan, M., Cormier, D. and Lapointe-Antunes, P. 2008. Like Moths Attracted to Flames: Managerial Hubris and Financial Reporting Fraud. Working paper, Concordia University.


## New EthicsCentre Members

Cade Associates Insurance Brokers Limited

**Cade Insurance Brokers Limited** is an independent general insurance brokerage operating in the GTA since 1996. We partner with leading insurance providers to offer a comprehensive range of personal and commercial lines products. As an active member in the community, we enjoy our participatory commitment with several local charities and not-for-profit organizations.

Heenan Blaikie

**Heenan Blaikie**, one of the leading law firms in the country, offers legal services to clients in Canada and abroad. Named one of the 50 "Best Workplaces in Canada", the firm looks for ways to contribute to its employees' personal and professional growth, help its clients in their missions to be more socially responsible, and, as a profitable business, give back to society. We are involved in several community and charity programs and favor sustainable development in how we operate our business.

ethicscentre.ca
Canadian Centre for Ethics & Corporate Policy




## YOU CAN REACH US AT:

One Yonge Street, Suite 1801,
Toronto, Ontario M5E 1W7

Phone: 416-368-7525
Fax: 416-369-0515
E-mail: editor@ethicscentre.ca
Web site: www.ethicscentre.ca
LinkedIn: ethicscentre
Twitter: @ethicscentre

Design & Layout: Context Creative
Printing: Courtesy of The Canadian Institute of Chartered Accountants.

Charitable registration number:
12162 1932 RR0001

## MANAGEMENT ETHICS

is published seasonally by EthicsCentre CA.
We welcome appropriate announcements, letters to the editors, short articles of 300 to 1,000 words (which will be subject to usual editorial processes) and suggestions from readers.

Back issues of Management Ethics are on-line at the Centre's web site. The opinions expressed in Management Ethics do not necessarily represent the opinions of EthicsCentre CA.

This newsletter may be reproduced without permission as long as proper acknowledgement is given.


## CALENDAR OF EVENTS

### LUNCHEON EVENT

**October, 3, 2012**

**Professor Leonard Brooks**, Professor of Business Ethics & Accounting, Director, Master of Management & Professional Accounting Program, Director, Diploma in Forensic Accounting (DIFA), Executive Director, The Clarkson Centre for Business Ethics & Board Effectiveness, University of Toronto

**David Selley** FCA, retired (1998) partner Ernst & Young and consultant in auditing methodologies, and corporate ethics and social responsibility

*Ethics & Governance – Developing and Maintaining an Ethical Corporate Culture*

### DINNER EVENT

**November, 7, 2012**

Ethics Centre Event goes to Ottawa,
The Rideau Club – 6 p.m.

Panel Chair: **Penny Collenette,** Adjunct Professor, Faculty of Common Law, University of Ottawa

Panelists:

**Barb Finlay**, Deputy Ombudsman, Office of Ombudsman of Ontario

**Peter Julian**, MP, Burnaby-New Westminster, BC. Official Opposition Critic for Energy and Natural Resources and National Caucus Chair

**Honourable John McKay**, MP, Scarborough-Guildwood, ON Liberal Party of Canada, Critic for Defense

*Business and Human Rights – Can These Two Partners Dance?*