Is the Party Over?
What’s Ahead for Private Equity?
It's no secret that universities across the nation, like everyone else, are feeling the effects of the economic downturn. Many state budgets are in a precarious condition, and public education is suffering the consequences of decreased appropriations. College endowments have tumbled along with the stock market, and corporations and individuals have had to reassess their charitable giving, all of which creates uncertainty in the higher education environment.

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Larry DeBrock
Dean
IS THE PARTY OVER?
By Doug McInnis
The recession has taken its toll on private equity. What does the future hold for this market?

FAST & FURIOUS
By Cathy Lockman
When the crowd provides ideas, businesses get lots of minds working for them — many of them for free.

LEADING GREEN
By Alice Shepherd
Reducing your carbon footprint is not only good for the environment, it’s good for business, too.

ONE THING LEADS TO ANOTHER
By Alice Shepherd
Unethical conduct doesn’t occur overnight. It’s an incremental process that can sneak up on a business and topple it.

OPPORTUNITY KNOCKS
By Cathy Lockman
What are the challenges and opportunities for U.S. companies doing business in China?

Is the party over? The one we staged for this issue’s cover photo with Ola Bengtsson, assistant professor of finance, is. But industry experts say the private equity party still has life in it, despite the economic challenges.
Is the Party Over?

Private equity has begun to recover from a two-year slide. But as the industry emerges from the recession, what was just recently a high-spirited gala with hundreds of guests is now a much smaller and quieter party. Today’s deals are fewer, smaller, and less leveraged, according to private equity insiders and industry trend data.

Private equity has an enormous impact on the economy. Through its leveraged buyout wing, private equity buys and reshapes companies; through its venture capital wing, it helps launch entrepreneurial companies that historically have produced large numbers of new jobs. At the same time, private equity has an immense impact on other segments of the economy, including Wall Street, pension funds, and endowments, all of which suffered from private equity’s downturn.
"In general, venture capital has no substitute because start-up firms are excluded from public capital markets and typically are too risky to attract attention. Many of today’s well-known technology companies, including Google, Apple, and Facebook, were initially financed by venture capital."

- Ola Bengtsson

The leveraged buyout industry is showing a pulse, as the number and volume of deals has crept upward in recent months. For firms that have the money, this may be the time to buy because prices have fallen. “During the industry’s heyday a few years ago, private equity firms had to pay steep prices for acquisitions, partly because there was so much financing available that drove highly competitive auctions,” says Stephen King, a founding principal of private equity firm Prairie Capital in Chicago and an ILLINOIS graduate in finance. “Now there’s not as much money out there, so there aren’t as many bidders and valuations are falling. To the extent that you have dry powder, it’s a great time to make investments. In the past year, we’ve bought three companies.”

Falling valuations have also created problems for the industry, however. Past buyouts still held by private equity companies have often fallen in value too, which means they will likely result in a loss if they are sold.

Meanwhile, the industry’s venture capital wing hasn’t recovered. In the long term, U.S. competitiveness may suffer from the plunge in venture capital investment. According to the Money Tree Report, which tracks industry trends, U.S. venture capital firms invested just $18 billion in 2009, down from more than $30 billion in 2007 and well below the 2000 peak of more than $100 billion. The cutbacks may starve entrepreneurial firms of cash needed to grow and ride out the downturn. "In general, venture capital has no substitute because start-up firms are excluded from public capital markets and typically are too risky to attract attention," says Ola Bengtsson, assistant professor of finance at ILLINOIS. "Many of today’s well-known technology companies, including Google, Apple, and Facebook, were initially financed by venture capital." "

Overall, the private equity industry’s current problems stem from two factors, King says. “One was the contraction in credit markets which began in the fall of 2007. More problematic was the recession.” The credit crunch deprived the industry of funds needed to do buyouts. The recession slashed the profitability of numerous companies already acquired through leveraged buyouts, and some went bankrupt, including Chrysler, which private equity firm Cerberus had acquired from Daimler-Benz.

Debt intensified the problems. As the name implies, leveraged buyouts use borrowed funds (loans and bonds), which are secured by the assets and the cash flows of the company being purchased. While this allows private equity companies to do more and bigger deals, it also puts more debt on the acquired companies—and this became a sizeable problem as the economy sank. "Leverage magnifies profits, but it also magnifies losses," says Bengtsson.

Putting on the Brakes

As the industry’s problems played out, the impact rippled through the economy. For instance, underwriters suffered because there were fewer public offerings for firms exiting the portfolios of leveraged buyout and venture capital firms. The mergers and acquisitions business also shrank, in part because buyout firms weren’t buying or selling as many companies.

Data compiled by Dealogic chronicled the damage. The volume of U.S. leveraged buyouts shrank tenfold, from $377 billion in 2007 to $35 billion in 2009. In the same period, the number of IPOs issued by private equity dropped from 94 to 28. And the volume of mergers and acquisitions fell from roughly $1.6 trillion to less than $800 billion.

Dirk Hackbart, associate professor of finance at ILLINOIS, researches the intricacies of mergers and acquisitions. He recently completed a draft paper with College of Business colleagues Heitor Almeida and Murillo Campello, which examined the potential for linkup between financially distressed firms and other firms with the liquidity to help them survive.

The researchers concluded that financially distressed firms may be acquired by liquid firms in their own industries even when the merger would not produce any “operational synergies.” In such cases, the main purpose of the merger would be to provide cash to firms that might otherwise go out of business, the trio concluded. Though the paper didn’t examine private equity, Hackbart says the concept could apply as well to private equity buyouts of good firms in financial trouble.

“For some firms, credit just dried up as a result of the financial crisis,” says Hackbart. “Very good businesses could not obtain the same funding they could five or ten years ago.” In that case, he says, “a private equity buyout could provide an injection of liquidity that would allow them to survive.”

For those businesses that do have the cash or can get the credit, the downturn can represent a strategic opportunity, says Hackbart. Take software giant Oracle, for instance. Since the beginning of 2008, cash-rich Oracle has acquired a dozen...
companies, including its 2010 acquisition of Sun Microsystems, which adds a hardware arm to the software company’s arsenal. Cisco, another cash-rich company, also has acquired more than a dozen companies in the last two years. The networking company even launched a $4 billion debt sale in 2009 for what they termed “general corporate purposes,” creating industry speculation that more acquisitions were in the works.

Let’s Make a Deal

Private equity has been around for some time in one form or another. In 1901, for example, Andrew Carnegie sold his giant steel company to a consortium headed by financier J.P. Morgan. The mammoth deal went through because Morgan stitched together financing from investors and borrowed funds—in other words, private equity, though nobody called it that back then. The acquisition became part of the newly created U.S. Steel.

The private equity industry took on more formality in the second half of the 20th century. The emerging high-tech economy needed cash to grow. Well-organized venture capital firms provided it. Meanwhile, the buyout business spawned formal private equity firms, such as Kohlberg Kravis & Roberts. KKR bought machine-tool maker Houdaille in 1979 for $355 million, in what was then a landmark deal. Just a decade later, KKR stunned the financial world with its $31 billion takeover of RJR Nabisco.

These emerging private equity firms came with a built-in advantage. Because they operate privately, “they don’t have to run their portfolio companies with an eye toward quarterly results,” says Prairie Capital’s King. “They can make strategic decisions for the long haul.” Before the recession, they had no trouble raising funds because they were often immensely profitable.

By the time the downturn hit, they had also become a major force in the economy. In just two years, from 2006 through 2007, private equity firms launched nine of the ten largest buyouts in history, according to data from Dealogic and Fortune Magazine.

The record buyouts included nearly $39 billion paid by The Blackstone Group for Equity Office Trust Properties, which owned more than 500 office buildings. The deal was done February 9, 2007—just as lightning was about to strike. Two days earlier, the big British bank HSBC reported larger than expected losses, primarily as a result of subprime mortgage loans gone bad. That story got seven paragraphs in the New York Times online, though in hindsight the HSBC loss was an early warning that the subprime bubble was deflating. By year’s end, subprime losses had triggered a credit crunch—and funds for leveraged buyouts were drying up.

Less Debt, No Regret

Because the private equity industry is stratified, some companies entered the recession in better shape than others. Prairie Capital, for example, typically buys small, high-growth, family-run companies and helps them grow. Prairie Capital does this with half or less of the debt levels found in other segments of the buyout industry. “Because we are buying high-growth companies, we’ve never wanted to put much debt on them,” says King. “And because we’ve never used much debt, we have more of an ability to withstand a downturn.”

The full extent of the damage to the industry from the downturn is hard to assess, because many private equity firms say little about their profitability. An exception is The Blackstone Group.
largest U.S. private equity firm, which reported net profits of $703 million for 2009, following a loss of $1.2 billion the year before. “We believe the worst is behind us,” Stephen A. Schwarzman, Blackstone’s chairman and CEO, said in a press release.

The deals are beginning to flow again, though hardly at the pre-boom pace. Today’s deals are fewer, smaller, and much less dependent on debt. “Credit is available,” David M. Rubenstein, co-founder of The Carlyle Group, said in an interview with Bloomberg News. “But if you want to do a $10 billion or a $20 billion buyout, I think that’s unrealistic in this day and age. Probably a $4 billion to $5 or $6 billion buyout can be financed, but you’d have to put in maybe 50 percent equity to get it done.”

Moving Forward

What does the future hold for private equity? Bengtsson notes that the prospects for the venture capital branch of private equity will depend less on the availability of credit and more on the quality of innovations. In the last several years, venture capitalists have made large bets on companies trying to commercialize renewable energy solutions, he says. If these solutions work well, then venture capitalists will realize nice returns and be able to attract more institutional funding. The prospects for venture capital will also depend on what happens to IPO and merger and acquisition markets. “Even if the companies in a venture capitalist’s portfolio are all doing great things, they must be sold to someone for the venture capitalist to make money,” Bengtsson says.

Hackbarth believes those investments will see a payoff. “It’s a good time to reenter the private equity and merger and acquisitions markets since they’re procyclical,” he says. “As soon as the economy picks up again, these investments will pay off because a more ‘normal’ valuation model will apply again. So prices will return to levels more similar to the ones prevailing prior to the recession.”

King also sees the current financial situation as an opportunity for private equity. “Coming out of a recession is a great time to make investments,” he says. Private equity still has some $400 billion in investor cash left to use for deals, according to industry estimates. King added a note of caution, however. Endowments and pension funds, which put up much of the equity for buyouts, didn’t get the hefty paydays in recent years that they had counted on. As a result, these institutional investors may not be eager to put more money in the pot in the future.

“There’s been a lot of pain felt in the last few years, and there’s still a lot of pain to be felt,” says King. “And while it’s a good time to be investing now, there is going to be some reluctance on the part of institutional investors to jump back in.”

– Doug McInnis


“DURING THE INDUSTRY’S HEYDAY A FEW YEARS AGO, PRIVATE EQUITY FIRMS HAD TO PAY STEEP PRICES FOR ACQUSITIONS, PARTLY BECAUSE THERE WAS SO MUCH FINANCING AVAILABLE THAT DROVE HIGHLY COMPETITIVE AUCTIONS. NOW THERE’S NOT AS MUCH MONEY OUT THERE, SO THERE AREN’T AS MANY BIDDERS AND VALUATIONS ARE FALLING. TO THE EXTENT THAT YOU HAVE DRY POWDER, IT’S A GREAT TIME TO MAKE INVESTMENTS. IN THE PAST YEAR, WE’VE BOUGHT THREE COMPANIES.”

– Stephen King
Ross Kimbarovsky was an intellectual property attorney at a Chicago firm when the idea for crowdSPRING came to him. He had persuaded his colleagues that the firm’s website needed to be redesigned, and he was put in charge of soliciting requests for proposal and selecting a vendor to create the site. When the agency presented their three designs, Kimbarovsky was not impressed. So he got online and stumbled on a site that featured the work of a small group of graphic design students from Malaysia who were having a competition among themselves. Their approach to design appealed to Kimbarovsky, and it got him thinking that there had to be a less complicated, less expensive way to find designers whose ideas matched a client’s vision.

At the same time, his friend Mike Samson, a television and film producer, was equally frustrated in his efforts to acquire post-production video services. They saw the need for a new business model and decided there was an opportunity to change the way people buy creative services. That was in mid-2006. In May 2008, they launched crowdSPRING, which allows businesses from across the world to access creative talent and provides designers, writers, and other creatives, also from around the world, with the chance to find new clients.

The concept is simple. If a business needs a logo, a website design, or other creative services, they post the specifics of their project, including the deadline and the price to be paid, on crowdSPRING. Graphic designers, web designers, writers, and other creatives who have joined the crowdSPRING online community can view the projects and submit their proposals.

“Many firms follow a closed innovation paradigm. That means that you generate your own ideas as a firm, you evaluate the value of each project, and you determine how it will work in your market. This model makes some fairly bold assumptions, namely that you have the best talent in the world working for you, that only you as a company knows what works best, and that sharing ideas will put you at a competitive disadvantage.”

– Raj Echambadi
the postings and submit design concepts for any projects they choose. If their work is selected by the business, they submit completed designs and are paid for their services; if their work is not chosen, they retain the rights to their design.

It’s quintessential crowdsourcing, which Jeff Howe explains in his book, Crowdsourcing: Why the Power of the Crowd is Driving the Future of Business, as “taking a job that was once done by an employee and outsourcing it in the form of an open call to a large undefined group of people generally using the Internet.” The crowd might be scientists solving complex problems, computer users offering solutions to technical glitches, or coffee drinkers weighing in on new menu items. In the case of crowdSPRING, it’s essentially an online creative department available to businesses all day, every day at a predetermined price. And what a large creative department it is, with a community of more than 52,000 creatives from 170 countries submitting work for buyers in more than 70 countries. For small- to medium-sized businesses, who can’t afford the services of an advertising agency, it represents a resource they’ve never had available to them before. How

crowdsourcing is part of a larger phenomenon called “open innovation,” which proposes that companies should be open to ideas that come from outside the firm not just to ideas generated within it. It’s a concept originally presented by Henry Chesbrough of the University of California at Berkeley, and one that Qualls and his collaborators, Raj Echambadi, associate professor of business administration at ILLINOIS, and Elisa Fredericks, associate professor of marketing at Northern Illinois University, are currently researching.

“New ideas can come from external stakeholders, including customers, competitors, suppliers, or a community of users,” says Qualls. “Crowdsourcing creates an opportunity for a large volume and a steady stream of ideas from a wide variety of resources. That alone creates value because you have a better chance of identifying something truly innovative when there are more ideas to begin with. Plus, the ideas are generated at a lower cost, which improves profit levels.”

If the potential benefits to a company are so great, why isn’t everyone jumping on the crowdsourcing bandwagon? Echambadi explains that it requires a change in the corporate mindset.

“Many firms follow a closed innovation paradigm,” he says. “That means that you generate your own ideas as a firm, you evaluate the value of each project, and you determine how it will work in your market. This model makes some fairly bold assumptions, namely that you have the best talent in the world working for you, that only you as a company knows what works best, and that sharing ideas will put you at a competitive disadvantage. These are sometimes restrictive assumptions, especially in turbulent times when creativity and innovation is of paramount importance, and firms must be willing to change their business model to harness the enormous amount of knowledge and the large talent pool available through the open innovation model.”

Boon or Bust?

What some businesses consider a potential boon, others consider a threat. And that’s true for individuals, too. For example, when iStockphoto, an early adopter of crowdsourcing techniques, was
launched in 2000, it welcomed photographers to submit images to the site and allowed others to download them for negotiated prices, often ranging from 25 to 50 cents each. Designers who were used to purchasing images from traditional stock photography companies that charged hundreds of times more were happy to now have a large portfolio to choose from and a low-cost solution for their photography needs. Professional photographers weren’t so thrilled.

Critics contended that it devalued the market and the profession and created thorny integrity issues regarding royalty and intellectual property rights. While that battle played itself out in blogs, Getty Images, a traditional stock photography company, watched the success of iStockphoto and decided if you can’t beat them join them. In 2006, they purchased iStockphoto for $50 million.

For Getty, iStockphoto was what Echambadi calls a “low-end disruptive innovation.” Because such enterprises start as a niche market, which targets customers who do not need the attributes valued by customers at the higher end, companies don’t always take them seriously, but when they’re successful they threaten existing firms so they have to take action to avoid becoming obsolete. Echambadi recalls the example of Polaroid, which was actually one of the product pioneers in developing a digital camera but abandoned the idea because it didn’t further their core business of selling film. Now Polaroid is gone altogether.

In retrospect, it was an ill-advised strategy, but one that many businesses follow as a way to protect their existing market. Echambadi advises a different approach.

“Instead of seeing innovation as a threat and worrying that someone will come in and take your sales,” he says, “businesses need to consider that it would be better to cannibalize themselves and move on. They have to be willing to adjust their business model and adopt open innovation practices.”

Collaboration Versus Competition

Kimbarovsky, a 1995 graduate of the University of Illinois Law School and a former research assistant in the College of Business, used open innovation strategies as he developed his business plan for crowdSPRING. He sorted through the legitimate criticisms waged against iStockphoto and created processes and procedures to address them.

“A core principle of our company is to rigorously protect intellectual property,” says Kimbarovsky. “We have created strictly defined standards of conduct in collaboration with our community of buyers and creatives, have a unique system of customized legal contracts for every project on crowdSPRING, and a system to make it easy for anyone to report and enforce any violations of intellectual property rights. Our focus on intellectual property is integral to our ability to build trust with buyers and creatives.”

Building that trust is central in a crowdsourcing environment where you rely on a community of “customers” who are really your collaborators, too. Kimbarovsky says crowdSPRING nurtures that trust by engaging the community in discussions and forums, listening to their suggestions, implementing changes, and committing to transparency.

“When you strike enough chords with your community, everyone begins to see the benefits of the collaboration and how healthy it is for competition,” says Kimbarovsky.

Echambadi agrees. “Collaboration is a far better way of succeeding than seeing everything as competition and holding all
From start-up companies built specifically with crowdsourcing as part of their strategy to established businesses dipping their toes into the concept, enterprises small and large, old and new are looking to harness the ideas generated by the online crowd. Here’s how some of them are doing it.

**Threadless:** This t-shirt company solicits designs from its online community weekly; the community votes on the t-shirts; and the most popular are manufactured and sold by Threadless to a market that’s already engaged in the process and has taken the time to weigh in on their favorites. The winning designer gets a stipend and free shirts, and Threadless gets ideas and feedback from people who are passionate about the process and the products and provide marketing by spreading the word.

**Lego:** The company that created the infamous plastic building blocks more than 50 years ago now invites Lego enthusiasts to go to their website, download design software, and create virtual versions of their own original designs. Lego retains the rights to all the individual creations, but the individual can buy a custom-made kit and box that includes all the pieces they used to create their virtual design so they can build the real model at home.

**Netflix:** The movie rental company had a system that recommended movies to users based on their previous selections. In October 2006, they announced that they would award a $1 million prize to the person who created a system that was 10 percent better than their own. Netflix opened their database of over 100 million real user ratings to contestants who then tried to develop an algorithm that would better predict the movies that Netflix users would like. The crowd weighed in; one member won $1 million; and the company got an improved system.

**InnoCentive:** This online marketplace matches organizations seeking solutions with a network of over 160,000 problem solvers. The organizations post challenges on the InnoCentive website and establish an award amount. Solvers submit solutions, and the organization pays the award for the solution that best meets the challenge’s criteria. Challenges range from specialized firms looking for scientific or engineering solutions to businesses looking for designs for new consumer products.

**Dell:** The personal computer manufacturer launched their IdeaStorm website in 2007 to solicit ideas from Dell users. Those who visit the website can post their own suggestions and rank the suggestions of others. From this input, Dell determines which suggestions are most important to their users and then updates users on the implementation status of the user-generated ideas. Users agree that Dell has the right to license and implement any posted ideas without compensation to the originator.

**Starbucks:** The coffeehouse chain has created an online idea blog that encourages customers to share their suggestions for improving products and service at their stores, comment on others’ ideas, and keep tabs on where in the Starbucks review process their ideas stand. Starbucks loyalists get to have their say, and the company has a mechanism to respond quickly to new ideas and affirm brand loyalty.

— Cathy Lockman
of your ideas close to your vest,” he says. “Collaboration brings diversity of perspectives, which means your company’s creativity is less likely to follow a predictable path, and that leads to a better business model in the long run.”

The Free Reveal

What is it that motivates the crowd to openly share their ideas often without any promise of remuneration? Echambadi speculates that some are driven by passion for a subject or have an altruistic motive; others are natural problem solvers who enjoy the challenge; and still others may participate to gain recognition from the crowd as an expert.

According to Kimbarovsky, there are some very practical reasons, too. “At crowdSPRING, many creatives are making meaningful income,” he says. “For some it represents a full-time job, for others a part-time business. Some are looking to change careers and use their work on crowdSPRING as an opportunity to create a portfolio with real clients and to leverage real feedback to gain practical experience. Our platform levels the playing field, which means the work is judged on its own merits and not on the experience or level of education of the person who created it. That allows people to break into the business in a way never before available. Plus, people can work remotely at their own pace and set their own hours.”

Sometimes being willing to reveal your ideas for free is the most practical way to have those ideas accepted or adopted, whether you’re talking about creating a Super Bowl commercial for Doritos, developing a new cleaning product for Procter & Gamble, or writing a product review for Amazon.

In this way, crowdsourcing is what Howe describes as “just one manifestation...
of a larger trend toward greater democratization in commerce. People don’t want to be just consumers; they want to help design and evaluate products and create services and solutions.”

Idea, Ideas, and More Ideas

Obviously, businesses that find a way to tap the collective knowledge of the crowd get much more than a strong dose of consumer goodwill. They reap some very tangible benefits, too, the greatest of which is sheer numbers. Instead of 100 ideas from their own employees, they might get ten times that many. And even if most of those ideas are of little value, you only need one good one to get you started. The bad ideas cost you virtually nothing, and the good ones have the potential to be a boon for your business. It’s a lesson companies are taking seriously. Take Procter & Gamble for instance, which traditionally had what Qualls describes as “an invent-it-here culture,” until a successful external idea for the Crest Spinner Brush prompted Chief Executive Officer A.G. Lafley to commit to obtaining 50 percent of their new product and service ideas from outside their own R&D staff. By making use of outside ideas, some of which were already far more than mere ideas and were already in some stage of development, Procter & Gamble could launch new products more quickly and at a lower cost.

But, Qualls cautions, crowdsourced ideas don’t come without some baggage, and that requires businesses to take on new roles. “Some firms have built their business on the crowdsourcing concept, and others have implemented it to fine-tune their business,” he says. “But we don’t yet have enough data to determine if it actually will work as a strategy for all firms and how it will fit in the new product development process. However, we do know that crowdsourcing requires a business to have a process in place to evaluate all the ideas that come in and to determine whether these are truly innovative ideas or just extensions of old ideas. Firms will need more absorptive capacity, that is, more mechanisms to recognize the value of the new information and its commercial application. And we need to examine whether there is a tendency for management to be biased toward internally developed ideas, and, if so, how companies deal with that bias.”

Concentrate on Core Competencies

Whatever the pitfalls of crowdsourcing, one thing is for certain: businesses will have to adapt. For advertising agencies, it may mean using companies like crowdSPRING to buy creative services instead of employing an in-house creative team. Kimbarovsky says he already has agencies that do that for some of their projects. “The businesses that think outside the box see the value of crowdsourcing and are ready to evolve to take advantage of it,” he says. “There’s a place in the market for advertising agencies and crowdSPRING. We provide the virtual design team, which allows the strategists and account managers to concentrate on executing the ideas and allows the agency to control costs.”

Patrick Vargas, associate professor of advertising at ILLINOIS, agrees that there is a role for crowdsourcing, but it has its limitations. “Hundreds of people can submit ad ideas,” he says, “and several of them are bound to be great, but ad agencies do much more than create clever ads. One thing that crowdsourcing cannot do is offer strategy for brands and businesses.”

To Echambadi, that’s a key point for an ad agency and any other enterprise. “Firms that concentrate on their core competencies and outsource the parts of their business that are not as critical to their competitive advantage are more efficient, can operate more cost effectively, and have far better results,” he says. “This is the new paradigm, and firms need to be ready and willing to harness the power that open innovation and crowdsourcing bring to their businesses. Those who don’t will be left behind.”

—Cathy Lockman

“Our platform levels the playing field, which means the work is judged on its own merits and not on the experience or level of education of the person who created it. That allows people to break into the business in a way never before available. Plus, people can work remotely at their own pace and set their own hours.”
—Ross Kimbarovsky
Reducing carbon dioxide emissions is not only good for the environment—it’s good for business, too. Smart energy management can help businesses control costs and optimize revenues for a better profit margin. After all, carbon emissions, or greenhouse gases, are just an unnecessary byproduct that companies pay for when they purchase energy—a byproduct they will have to pay for again when they dispose of it if the proposed carbon tax or cap-and-trade system is imposed. And if cost savings isn’t reason enough to examine energy use, environmental concerns are also driving socially responsible businesses to reduce their carbon footprint. So what’s the most effective way to go about it?

How Big Is Your Carbon Footprint?

“A carbon footprint is a measure of the carbon emissions that are caused through the activities of an organization,” says Eric Jackson, a senior carbon expert at the University of Illinois’ Environmental Change Institute and chief sustainability officer of Conservis, a company that provides assessment, education, evaluation, and implementation of sustainability information systems. “The World Resource Institute and the World Business Council for Sustainable Development have developed a protocol, methodology, and nomenclature for carbon accounting,” says the ILLINOIS agricultural economics graduate. “Their work has become widely adopted and informs the Chicago Climate Exchange and the European trading scheme for carbon.”

The size of a company’s carbon footprint depends on the emissions scope it chooses for measurement. Scope 1 measures only the emissions a business generates from on-site combustion (e.g., through factory equipment, vehicle fleet, and HVAC systems). Scope 2 adds the
Measure and Improve

Don Fullerton, professor of environmental economics, believes that the way companies currently account for their carbon footprint is too vague. “If they had to pay a tax, they would have to develop more rigorous emission measures,” he says. “Voluntary programs are insufficient to solve the huge problem of global warming. We have to get serious.”

Sustainability information systems can improve carbon accounting and reporting, says Jackson. “CFOs are not used to dealing in kilowatt hours and gallons of fuel,” he notes. “They need software—similar to a traditional financial accounting system—that can capture information on energy goals and mandates, too, but the problem is that natural sources such as wind and solar often produce energy when demand is low. “The solution is to blend energy from various natural and traditional sources, direct energy to storage in periods of low demand, and then release it from storage when demand peaks,” says Tolen. “Truckloads of used vehicle batteries, whether lead acid or nickel metal hydride, can be arrayed into pallets to provide low-cost storage for wind or solar energy.”

The last step in carbon management is for organizations to purchase carbon offsets to support energy-efficiency improvements by another company, which is then granted credits by the Chicago Climate Exchange, the only operational voluntary cap-and-trade system in the United States. “While this measure is cheaper than steps 2, 3, or 4, it only reduces a company’s emissions in an accounting sense as it supports someone else’s clean-tech project, perhaps half a world away,” says Jackson. “This scheme is voluntary today but could exist tomorrow in a regulated market under a cap-and-trade system.”

“Reporting agencies such as the Global Reporting Initiative, the Carbon Disclosure Project, and the Climate Registry are valuable because they encourage measurement—and that which is measured tends to improve.”

– Jon Anda
energy use and savings across the enterprise, store it, make it accessible for analysis, and report on it. Having accurate data helps demonstrate the ROI of sustainability projects and improves decision-making. It allows companies to issue corporate social responsibility (CSR) reports that are data-rich and audit proof.”

In addition to publishing CSRs, many companies are voluntarily disclosing their carbon footprint or broader sustainability metrics. About 3,500 companies report to the Global Reporting Initiative, about 2,500 to the Carbon Disclosure Project, and about 350 to the Climate Registry. “Reporting agencies such as these are valuable because they encourage measurement—and that which is measured tends to improve,” says Jon Anda, an ILLINOIS accounting graduate, a visiting fellow at the Nicholas Institute for Environmental Policy Solutions at Duke University, and founder of CleanEnergyProductivity.org.

Regulatory reporting requirements are just emerging. “U.S. sites that are emitting 25,000 metric tons of carbon dioxide or more as of January 1, 2010 will have to report to the EPA beginning next March,” says Jackson. “In addition, the SEC has issued advisory guidelines for public companies, asking for disclosures in 10K reports, and the FTC has published standards for making green claims on products.”

Why Go Green?

Four basic value propositions spur sustainable practices: cost reduction (steps 2 and 3 above), risk mitigation, revenue growth, and green brand equity. Risk mitigation is sector specific. “In addition to SEC, FTC, and EPA regulations, non-regulated specifications from industry are also forcing behavior,” says Jackson. “An example of a marketplace ‘specifier’ is Walmart, which demands disclosures of its supply chain. Watchdog groups, too, score behavior in the public domain, and the media can hammer a company that lacks the data to tell its own story.”

The flipside of risk is green brand equity. Customers and investors are creating market conditions that encourage non-regulatory compliance. Being included in the Dow Jones Sustainability Index, for instance, equates to a five percent bump in market cap, says Jackson, and Anda points out that clean tech is hot in the venture capital community.

Finally, as consumers today look for sustainable choices, innovative manufacturers are raising their revenues by redesigning their products. They are incorporating more sustainable components or making their products more energy efficient or recyclable.

“Companies are anticipating legislation,” says Anda. “Even polluters that are fighting legislation in Washington have realized that the world is going to de-carbonize. They are already making plans to reduce emissions dramatically.”

However, Anda does not believe that voluntary actions will lead to the desired 83 percent reduction in U.S. carbon emissions by 2050 or help stabilize the climate at a two-degree Centigrade increase from the pre-industrial era. “We need a new architecture to supplant voluntary actions and drive a large reduction in emissions, with the co-benefit of using less imported oil,” he says. “The key is not to lose our momentum again the way we did in the 1980s as soon as oil prices dropped from historic highs. We can’t lose out to the Europeans and the Asians, who are rapidly surpassing the U.S in low-carbon energy investment and, in some cases, technology.”

Cap and Trade or Carbon Tax?

Among mandatory measures, Fullerton favors a carbon tax, which would generate revenue for the government. “Cap and trade is corporate welfare,” he says. “The government would hand out free permits worth $100 billion to existing polluters who could sell them for cash.

New entrants get no such benefit. If the government were to sell the permits instead, it would be similar to a tax, and the revenue could be used to reduce other corporate taxes on workers or on investment. But a downside of cap and trade is that it might be difficult to maintain any fiscal discipline. Congressmen would want to give permits away to firms with ‘special circumstances’—and it’s all downhill from there.”

Neither a carbon tax nor a cap-and-trade system is likely, says Fullerton, because politicians are worried about the next election. “Instead they will support largely ineffective targeted subsidies or CAFE standards on corporate average fuel economy,” he says.

Fullerton recently consulted with the European Union’s 27 finance ministers. “Several European nations have a carbon tax,” he says, “and there is a cap-and-trade permit system for all 27 countries, but it only applies to the electric generating sector and major industries—about one half of the carbon emissions. They’re considering a carbon tax for the other half.” Fullerton told the finance ministers the same thing he’s told U.S. lawmakers: forget the cap and trade—a simple tax is fair and will make a difference.

Anda, on the other hand, favors “cap-and-dividend” legislation (called CLEAR in the current Senate bill), where sellers of coal, oil, and natural gas must buy permits for all sales—and 3/4 of permit revenue is returned to citizens on a per-capita basis.

“As we build our low-carbon economy, the capabilities of the University of Illinois are absolutely critical,” says Anda. “BP has awarded a big grant to the U of I and to the University of California, Berkeley, to develop bio-fuels. Leveraging ILLINOIS’ capabilities in agriculture and engineering can have a great impact.”

- Alice Shepherd

“Having accurate data helps demonstrate the ROI of sustainability projects and improves decision-making. It allows companies to issue corporate social responsibility reports that are data-rich and audit proof.”

– Eric Jackson
Opportunity Knocks

“To get rich is glorious.” That’s what Deng Xiaoping told the Chinese people three decades ago as he initiated the reforms that unshackled his country’s economy and set China on a new course. It’s a mantra that has continued to play itself out in China over the last 30 years, a period of unprecedented growth and wealth creation for the Chinese. Of course, they aren’t the only ones who have benefited. It has also been a boon for those around the world who seized the opportunities to do business in China. Today, the potential payoff continues to be huge for businesses that are nimble enough and innovative enough to take the plunge and navigate the challenges.
Chris Lu, the chief executive officer for Deloitte China, has witnessed the economic transformation firsthand. Lu grew up in Taiwan and graduated from ILLINOIS with a master of accounting science in 1980. He went on to work in Deloitte’s Los Angeles and Taipei offices before transferring to Shanghai in 1994. The office had only been open for six months and had a staff of 30 when he arrived, and the Shanghai financial district itself was little more than open fields. Today, there are more than 8,000 people working in Deloitte’s 12 China offices.

“The pace of growth has been phenomenal,” says Lu. “The Chinese economy has emerged from a backward model to a progressive one in a very short period of time. China has become a very influential player in the global economy and a very fierce battleground for international competition. The world’s best companies are here, and you have to be world class to compete.”

Ira Solomon, head of the ILLINOIS Department of Accountancy, has seen the changes, too, as he’s worked to form strategic partnerships with universities in the region. “The rapid pace of change is unlike anything we’ve seen in the last 50 years,” says Solomon. “The sheer scale and number of people creates unique challenges. For instance, in most developed economies, the thinking is you need one-tenth of one percent of the population to serve as CPAs in order to meet the needs of the country. In China, therefore, where there are 1.3 billion people, they need about 1.3 million CPAs or their equivalent. Many sources report that right now there may be fewer than 100,000.”

Josephine Su, a 1994 MBA graduate and the vice-president of procurement for Honeywell in Asia, also sees China’s growing economy creating an extraordinary demand for workers that is difficult to keep up with. “The pace of growth has been so steep that there is a gap in terms of talent and training in many professions across the country,” she says. “Finding the right people to help you develop the market or develop a strategy to develop the market is one of the largest challenges for companies doing business in China,” she says. “Plus, the most suitable local people are in high demand.” The local workers are needed to help the Western company understand the Chinese culture, and those same workers must be able to understand the culture of the Western company. A tall order, for sure.

The Cultural Divide

Just what are those cultural issues? Of course, there are practical matters, like understanding the expectations of social and business protocols as well as the complexities of the language. Joseph Cheng, professor of business administration, says becoming proficient in those areas is extremely important to developing strong business relationships in China. “Too much

“Just like anything else, cultural differences provide challenges but also opportunities. Be open to the way the Chinese do things and be ready and willing to learn from them. Doing this is not a cost of business, it’s truly a benefit even for the most successful companies.”

– Chris Lu

“The Chinese government is now pumping money into their economy and urging consumers to spend. This is a great opportunity for U.S. firms; however, to be successful they’ll need to design products for the Chinese market that the local consumers can afford, not simply adapt a product originally designed for the U.S. market. This means investing in the local market and taking a long-term perspective to conducting business in China.”

– Joseph Cheng
can get lost in translation,” he says. “Foreigners need to learn the Chinese language and local culture. You just can’t rely on translators to do the work for you.”

But the biggest cultural issues are not the obvious practical differences, he says; they’re the systematic ones. “Recognizing these differences is the first step to building a successful strategy for conducting business in China,” Cheng says. He points to the interconnectedness of business and government in China, for instance, where many business decisions are driven by national or local politics and where many businesses are state-owned. “It’s vital that foreigners learn about how the Chinese government works at both the national and local levels and how the government influences business decisions in order to do well in China.”

Lu suggests that Western companies also familiarize themselves with local labor and tax laws if they want to be successful in China. “It’s important to understand the differences in the use of legal remedies in the system where you’re doing business,” he says. “Just because some actions are legal or illegal in your country, doesn’t mean those same laws exist in another jurisdiction or that the legal system is the best way to resolve issues.”

Beyond the legal contract, says Lu, is the all-important “social contract,” which he describes “as understanding the relationship between employers and employees, meeting expectations, and mastering the process of sustaining relationships of trust.” For Western companies that means understanding that China has traditionally been a country where employment was lifelong, where terminations were nonexistent, and where companies provided all the social benefits for employees. “As the social responsibility for employees begins to move from the employer to the government through reform, these expectations are starting to change, but it will take time to evolve,” he says.

Other work-related expectations also pose a challenge, according to Su. “In the West, we practice matrix reporting, where employees need to be flexible and go beyond their defined roles to be successful. It’s very difficult for Chinese natives to grasp and thrive in that kind of environment because the Chinese system is more top-down, where people have specific roles,” Su suggests that Western companies look at implementing matrix reporting only for the most skilled workers. “If you implement it at the wrong level, it can be devastating for both sides, with the Chinese feeling they aren’t getting support and direction and the Western company thinking the Chinese workers aren’t capable.”

Such misunderstandings are part of a cultural divide that some believe is the fundamental challenge for foreign companies doing business in China—that is, the system versus the individual. Stephane Grand is an attorney and an expert in Chinese law who founded a financial and tax advisory firm that specializes in assisting foreign companies doing business in China. At a recent College event, he explained the challenge as he sees it.

“In the West, we live as individuals. We believe that we’re equal to the government in court and that we’re equal to each other. That is not a concept that applies in China, where they are used to living within a system and find it difficult, if not impossible, to live without the parameters and hierarchy of that system. And, of course, we are not part of that system and never will be.”

While Su agrees that the Chinese are “used to fitting into a system and are comfortable with that,” she also sees that mentality changing as international companies adapt to Chinese
expectations and vice versa. Plus, the huge numbers of new, younger Chinese workers, many of whom have very different employment expectations than their older counterparts, have the potential to make significant changes in that system mentality.

Lu agrees, saying that the Chinese people and Chinese companies are adapting at a phenomenal pace and that the cultural divide is narrowing. “Over the last 20 years, there has been enormous cultural change inside China,” he says. “The younger generation is embracing this change through travel and technology, which exposes them to the world beyond Chinese culture. It gives them the opportunity to build on the strengths of their culture, of which there are many, as well as understand and adapt to the cultures of others.”

Tackling Corruption

If “to get rich is glorious,” then there are likely to be some who use unscrupulous methods to get there. According to Grand, corruption is not only commonplace, it is accepted in China. It’s a practice that he says “has built fortunes for many in China and has only recently been criminalized.”

The corruption problem is certainly real, agrees Solomon, but he cautions the West to remember that no society is free of corruption, and that’s especially true in a situation like China’s where there has been a rapid evolution from state-run enterprises to privatization. “There is a threat to the growth of any economic system if it doesn’t tackle the problem of corruption,” he says.

It’s a problem that Cheng also agrees is a challenge for the Chinese, not only because it is a long-established practice but because of how corruption is defined and perceived in the East and the West. He says that “all the recent news about the scandals on Wall Street and U.S. officials doing corrupt things, like the former Illinois governor allegedly trying to sell a Senate seat for personal gain,” leave the Chinese wondering about the West making corruption charges against the East. “This is a very sensitive subject,” Cheng says, “and it requires great diplomatic skill to address the issues in ways that protect the integrity of business conduct without insulting the other side.”

Made in China

If all these challenges aren’t big enough, U.S. companies looking to make inroads into the Chinese consumer market have some additional hurdles.

Grand says the Chinese consumer is “difficult to corner” and that “Chinese companies are better at understanding their needs and wants.” But the sheer numbers of middle class Chinese consumers, which Su estimates will reach upwards of 600 million in the next decade, mean U.S. businesses better beef up their learning curve and fast, or they’ll risk missing out on an unprecedented economic opportunity.

“The West used to view the Chinese consumer market as a factory,” says Su. “But that view is changing, and many in the West now see the
potential to experience the highest growth they’ll probably ever see in a 10-year period by tapping the Chinese consumer market.”

Su points to Kentucky Fried Chicken as a model of success that other Western companies should follow. “KFC has reinvented themselves in China by thinking locally,” she says. “They have localized their menu with international selections. Their profitability is phenomenal, and they’re opening 10 stores every month. If Western companies think like the Chinese, as KFC has done, they will reap incredible benefits from the Chinese consumer.”

But they better move quickly and be ready to listen to the consumers. “The biggest challenge for a Western company in the consumer market is the Chinese competitors,” Su explains. “They have caught up, so if a Western company hasn’t yet entered the market they are behind to begin with.”

Cheng adds: “The Chinese government is now pumping money into their economy and urging consumers to spend. This is a great opportunity for U.S. firms; however, to be successful they’ll need to design products for the Chinese market that the local consumers can afford, not simply adapt a product originally designed for the U.S. market. This means investing in the local market and taking a long-term perspective to conducting business in China.”

Great Wall or Great Opportunity?

What other steps can U.S. businesses take to overcome the challenges of doing business in China? Grand offers this advice: “Be strict about controls. Conduct your business in China the way you would in the West, even when you might feel pressured to do otherwise. There are lots of hurdles, but it is possible to be successful. You just have to understand how the system works. You don’t have to follow it, and in most cases you shouldn’t, but you do need to understand how it works.”

Lu also says understanding is vital, but he sees the process in a much more optimistic light. “Just like anything else, cultural differences provide challenges but also opportunities if you’re willing to adapt to them.” He recommends investing time and resources to understand the way the Chinese government and economy work and the basic culture of Chinese management and employees. Rather than strict adherence to your Western practices, as Grand suggests, Lu advises that U.S. businesses “be open to the way the Chinese do things and be ready and willing to learn from them.” That may mean pursuing different strategies for organizational development and financing operations, for instance. “Doing this is not a cost of business,” Lu says. “It’s truly a benefit even for the most successful businesses.”

Western companies also need to be more nimble according to Su. “In China, things move so fast that it’s literally, ‘You snooze, you lose.’ In the West, we require lots of time for analysis, prediction, and projection. Indigenous Chinese companies move much more quickly; they have a very entrepreneurial mentality and take risk. The Chinese believe that if you build it they will come, which mirrors the Chinese government’s mentality. Western companies need to tweak their own mentality and be a little less analytical and a little more risk-taking to take full advantage of the economic opportunities.”

Solomon believes that it’s important for both the West and the East to be open to what each can learn from the other, and while that means examining differences, it also means seeing the similarities. “The Chinese people are more similar to us than many people think,” he says. “They are very aware of the world, they want good things for their children, they’re willing to sacrifice, and they truly value education. At this point their infrastructure and their system is inadequate to meet the needs of the sheer numbers of people, but the Chinese are the most ‘capitalist’ people on the planet, and I mean that in the best sense of the word. They are world-class entrepreneurs, and forging business, education, and personal relationships with them is more than an economic opportunity; it’s a political and social necessity.”

– Ira Solomon

“THE CHINESE ARE WORLD-CLASS ENTREPRENEURS, AND FORGING BUSINESS, EDUCATION, AND PERSONAL RELATIONSHIPS WITH THEM IS MORE THAN AN ECONOMIC OPPORTUNITY; IT’S A POLITICAL AND SOCIAL NECESSITY.”

– Cathy Lockman
After the biggest corruption investigation in history, engineering conglomerate Siemens AG agreed in December 2009 to pay more than $1.3 billion to settle charges in the United States and Germany. In addition, it created the Siemens Integrity Initiative, which will distribute $100 million over 15 years to nonprofit organizations to support global efforts to fight fraud and corruption. In a form of institutionalized corruption, the company had allegedly been securing contracts around the world by systematically funneling about 1.3 billion euros in bribes through slush funds.

While global cases such as this capture the media’s attention, corruption can happen anywhere. It usually has subtle, almost unrecognizable beginnings. “Corruption can start in the back of a cab at the end of a negotiation, during a dinner discussion, when applying for a license, or in the process of signing a contract,” says Gretchen Winter, executive director of the Center for Professional Responsibility in Business and Society at ILLINOIS. “It happens so quickly that sometimes you don’t even realize it, and you rarely have time to think too deeply before you respond.”
The accounting scandals of the early 2000s prompted the passage of the Sarbanes-Oxley Act of 2002 (SOX), which requires companies to enhance and/or implement ethics and compliance programs. Despite SOX and other legislative initiatives, including The United States Foreign Corrupt Practices Act of 1977, the Organization of Economic Cooperation and Development’s (OECD) Convention on Combating Bribery of 1997, and the United Nations Convention Against Corruption of 2004, scandals make the news almost every week. Abhijeet Vadera, a doctoral candidate in business administration working with Associate Professor Ruth Aguilera at ILLINOIS, suggests one possible explanation for the ineffectiveness of SOX. “Companies simply copy an ethics and compliance program from an industry peer, and their training programs amount to little more than a 20-minute online test,” he says.

In general, one-size-fits-all laws are ineffective, says Aguilera, a fellow at the Center for Professional Responsibility in Business and Society. “‘Hard laws,’ such as SOX, seek to strengthen corporate governance through legal rules that cover all companies operating in a particular jurisdiction,” she explains. “Compliance usually amounts to window dressing. Companies publish the necessary policies, but don’t invest the resources to make them effective. In the area of finance, for example, the law is so rigid that companies circumvent it by entering a gray area. While they remain legal, they are really violating the principle of the law.”

By contrast, “soft laws” are voluntary codes of good governance or codes of ethics, which Aguilera believes are more effective. “Self-determination theory holds that people don’t want to be told what to do, but will go the extra mile for something they believe in,” she says.
“Some European countries, for instance, have best practice recommendations regarding the behavior and structure of the board of directors. Companies have to comply with these codes of good governance or disclose the reasons for noncompliance. The flexibility to adapt or mix various practices may help them tailor corporate governance to diverse organizational environments. Giving good quality explanations for noncompliance is associated with higher corporate performance than box-ticking compliance.”

Codes of good governance have spread around the world, encouraged by transnational organizations such as the European Commission, the World Bank, and the OECD. The Equator Principles is one such example. This voluntary set of standards for determining, assessing, and managing social and environmental risk in project financing, is modeled on the environmental standards of the World Bank and the social policies of the International Finance Corporation.

Culture Matters

Organizational culture plays a huge role in either condoning or fighting unethical practices. The design of formal compliance and training programs is just the beginning. “A less formal, but very important aspect is how you treat your employees,” says Vadera. “If you are honest with them, compensate and promote them fairly and systematically, and communicate openly about organizational decisions, then the citizens of your organization will mimic those behaviors in dealing with their colleagues, subordinates, customers, and other stakeholders.”

He recommends customizing ethics programs not only to the company, but to specific groups, and phasing in their implementation. “Start by focusing on the departments that need it the most,” he says. “For example, you could begin with the purchasing department, training employees about relationships with vendors. Later, deal with departments which focus on internal logistics and may have less exposure.”

A greater voice for shareholders in corporate governance also may help keep companies on the straight and narrow, Aguilera suggests. “Shareholder access to ballot,” for instance, permits shareholders to set the agenda for shareholder meetings and nominate directors that represent their interests, and the “say on pay” proposal currently in the Senate would allow shareholders to vote on the pay of directors and top management. “This is quite common in Europe, and in the U.K. it’s law,” says Aguilera. “Greater shareholder control and higher levels of disclosure may help stem the tide of corruption.”

“It’s difficult to measure the effectiveness of anti-corruption policies and programs because you can’t easily measure a negative,” says Winter. “Only a small number of companies require people to report requests that were refused. Creating a standard against which employees can measure their conduct can nip some problems in the bud.” Vadera suggests that the success of an anti-corruption program could be measured longitudinally over time by tracking the frequency of incidents before and after implementing the program.

“Corruption is usually the result of cumulative processes. For instance, your golf partner may ask you to change the score, and if you’re willing, the next request may be to change some numbers at work. It happens slowly and incrementally as you establish a pattern of conduct.”

– C. K. Gunsalus
Bad Economy, Good Ethics

The Ethics Resource Center conducted a National Business Ethics Survey in 2009, talking with more than 3,000 randomly chosen employees across the country to assess their attitudes toward ethical conduct in the workplace. This year’s results showed improvement over the findings reported in the last survey conducted in 2007: misconduct is down, reporting of misconduct is up, ethical culture is stronger, and pressure to violate ethics is lower. The only negative trend was in the perception that a report resulted in some form of retaliation, ranging from feeling excluded to verbal abuse.

Surprisingly, these positive findings were achieved during a period of significant economic upheaval and followed a trend also seen in another turbulent time, 2002-2003. Both were periods of high-profile business scandals and failures followed by strong government intervention and the threat of not only stepped-up enforcement but prosecution. The ERC offers a possible explanation: “During hard times, when a company’s well-being or even existence may be on the line and regulators are watching, management talks more about the importance of high standards to see the organization through the crisis. It may also be that some are less inclined to commit misconduct when management is on high alert.” This could lead to what the report termed an “ethics bubble” that could burst when the economy turns around unless leadership takes decisive and deliberate action to raise the bar for ethical conduct.

To learn more about the survey results and what business leaders, policy makers, and ethics professionals can do to create a strong ethical climate, visit www.ethics.org/nbes.

– Cathy Lockman

Whistle-blowing Do’s and Don’ts

According to the Association of Certified Fraud Examiners, tips, mainly from employees, are the most common way in which fraud is detected. Yet, according to The Hudson Employment Index, only half of the 31 percent of U.S. employees witnessing ethical misconduct actually report it.

What makes people report unethical practices, and how can whistle-blowing be encouraged?

Vadera has studied what motivates people to report unethical practices as well as the factors that influence them not to report it. “The results were counterintuitive,” he says. “The decision to report or not report was not based on a cost-benefit analysis. It was mostly an emotional process. People who were morally outraged when they observed wrongdoing wanted to report it, even when it meant possible job loss.”

Gunsalus teaches emerging professionals how to avoid situations in which they have to become whistle-blowers. Her advice is to establish a pattern of ethical conduct from day one. “As you interview for a job, express the values that matter to you and your interest in the company’s ethical climate,” she says. She also teaches students how to build an “ethical cushion” that will support them in the unlikely event of extreme consequences (e.g., losing a job) for blowing the whistle. “Arrange your finances so that you will never go hungry or miss a mortgage payment because you decided to ‘do the right thing,’” she says. “Live beneath your means and in congruence with your values so you won’t have to choose between feeding your family and being able to look at yourself in the mirror in the morning.”

Gunsalus has developed rules of conduct to follow when considering whether to report perceived misconduct: Consider alternative explanations; ask questions rather than making charges; identify the documentation that supports your concerns; separate your personal and professional concerns; assess your goals; and, finally, seek advice and listen to it. Her caution to whistleblowers is to manage emotions. “It
TRAINING THAT CREATE A CULTURE AND AN ATMOSPHERE IN WHICH EMPLOYEES KNOW ETHICAL BEHAVIOR—FROM THE TONE AT THE TOP TO POLICIES, GUIDELINES, AND TRAINING THAT CREATE A CULTURE AND AN ATMOSPHERE IN WHICH EMPLOYEES KNOW THAT DOING THE RIGHT THING IS THE ONLY THING TO DO—EVERY TIME.

– STEVE VAN ARSDELL

The Culture of Ethical Behavior

Too often organizations have assumed that ‘unethical behavior won’t happen here,” says Steve Van Arsdell, who received both his bachelor’s and master’s degrees in accountancy from ILLINOIS and now serves as deputy chief executive officer of Deloitte & Touche LLP, the audit and enterprise risk services arm of Deloitte LLP. “But it can happen anywhere.”

Van Arsdell, past chairman of the Governance Committee of the Board of Directors of Deloitte, explains how critical a high standard of ethical behavior is to the success of every organization.

“Nothing is more effective in promoting ethical behavior than the tone set by leadership,” he says. “The board and senior management are responsible for establishing guiding principles and ethical standards and for making sure all employees know that unethical behavior is not tolerated.”

Translating its principles and standards into the operating environment, Deloitte has created an open, collaborative atmosphere and built control systems to promote ethical behavior. Following the same advice it provides to its clients, Deloitte offers different avenues for people to report behavior they believe to be inconsistent with its values. Employees can go through regular reporting channels in their functional areas or call hotlines to make reports anonymously. They know that the organization is committed to responding and investigating issues promptly.

Deloitte personnel participate in extensive annual continuing education, which includes substantive ethics and compliance training. “We constantly emphasize the need to view everything we do from the perspective of the highest quality,” says Van Arsdell. “Both explicit and implicit within that focus on quality is the ethical context in which we operate. Training is provided in a myriad of formats including classroom settings, self-study, and facilitated and self-directed online learning. We’re not just fulfilling a regulation or compliance obligation, but we are instilling a culture of continuous improvement based on the highest ethical standards. To that end, Deloitte has recently broken ground near Dallas on a new 700,000+ square foot, state-of-the-art learning facility which will open in 2011 and be the hallmark of Deloitte’s learning and development culture.”

“Just 25 years ago, people commonly spent their entire careers at a single company,” says Van Arsdell. “Today many will have multiple employers during their careers. As a result, it is more important than ever that organizations clearly and consistently promote ethical behavior—from the tone at the top to policies, guidelines, and training that create a culture and an atmosphere in which employees know that doing the right thing in the right way is the only thing to do—every time.”

– Alice Shepherd

Can We Talk?

Winter’s fondest hope is that frank discussions of professional responsibilities and ethical dilemmas will someday be part of everyday corporate conversation, just like sales targets and financials.

“Creating such an environment depends on a well-implemented ethics and compliance program and a corporate culture that values candor and engagement,” she says. “The Siemens case ought to be required reading for every management team around the world. What happens when you compare it to your company’s practices? Unless you have open, reflective conversations, you won’t know until it’s too late.”

– Alice Shepherd

can be very stressful to speak with an investigator,” she says. “Any emotions you display may be taken as a sign of lack of credibility or malicious intentions.”

Gunsalus has witnessed many investigations that derailed because people became sidetracked by personalities, emotions, and positions rather than basing their conclusions on evidence and fact.

“Many cognitive biases affect human interaction, and we have to learn to safeguard against them,” she says.

Leadership plays a key role in cultivating an ethical environment and avoiding the need for whistle-blowing. “Leadership has to walk its talk,” says Gunsalus. “Leaders have to think about, talk about, and act in an ethical, honorable way that consistently embodies the organization’s values and codes and provides a core reference for decision-making. The steps are: Send the right messages; provide guidance for the well-intentioned; create an environment where it is safe to ask questions; develop appropriate responses; respond to problems; and enforce consequences.”

The Center for Professional Responsibility in Business and Society teaches students what to consider when making ethical decisions. “We provide them with a framework and give them experience and practice articulating their positions,” says Winter. “We hope to instill the confidence to exercise sound judgment when they confront potentially corrupt activity in the workplace.”
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