

Ethics Programs: Federal Imperative, Cultural Opportunity

FMI Corporation Locations

Raleigh - Headquarters
5171 Glenwood Avenue
Suite 200
Raleigh, NC 27612
Tel: 919.787.8400
Fax: 919.785.9320

Denver
210 University Boulevard
Suite 800
Denver, CO 80206
Tel: 303.377.4740
Fax: 303.398.7291

Phoenix
5080 North 40th Street
Suite 245
Phoenix, AZ 85018
Tel: 602.381.8108
Fax: 602.381.8228

Tampa
308 South Boulevard
Tampa, FL 33606
Tel: 813.636.1364
Fax: 813.636.9601

www.fminet.com

When contractors speak of their success, they rarely mention ethics policies, though ethics has become a defining issue for the design and construction industry. Driven in part by regulatory pressure, ethics programs are gaining prominence within firms whose leadership have made it a priority, and further throughout the industry, supported by associations like the Construction Industry Ethics and Compliance Initiative (CIECI) and the Associated General Contractors of America (AGC). Adhering to Federal Acquisition Regulation (FAR) is only a small part of instituting a formal ethics program. Breathing life into a written program so that it permeates the culture of a company is the true challenge and test of an effective ethics program, and requires superb leadership. The firms that have already made a commitment to building a vibrant ethical culture have taken great steps to counter negative perceptions of the industry. They have also paved the way for others to create formal ethics programs, and in doing so invest in their own long-term survival and vitality.

To date, little research has focused on ethical practices within the design and construction industry, though we know the costs of unethical behavior are significant. FMI's 2004 ethics survey of individuals within the construction industry estimated a loss of between \$5,000 and \$50,000 per million dollars spent on a project due to unethical behavior. FMI has conducted preliminary research to explore what motivates architectural, engineering and construction (AEC) firms to invest in ethics programs, and how they facilitate awareness and enforcement of ethics policies. Members of the CIECI and clients of FMI spoke about their experiences piloting ethics and compliance programs, the result of which is this research paper, designed to isolate best practices for developing an ethical culture. This article is intended as a prelude to a more rigorous investigation of specific issues resulting from the research.

Why are ethics important?

The AEC industry is grappling with ethics at present much in the same way it once did with mandatory safety standards. Some firms are ahead of the curve, and have already instituted ethics training programs and internal audit mechanisms, while others are scoping out the interplay of legal requirements and cultural values. Increasingly stringent federal reporting standards and ongoing modification of FAR language burdens both federal contractors and public companies. The Federal Sentencing Guidelines and the 1996 Caremark case prompted many companies to develop compliance and ethics programs. Commentary on current requirements is contained in the side bar "Ethics goes FAR in federal contracting." Private owners are also beginning to pay attention to ethics during selection of contractors; the government might have provided the nudge, but the entire industry has moved into an era in which ethical conduct is a non-negotiable. While the recession may have stalled the rapid development of ethics programs outside of federal work, sustained competition as the industry recovers will likely place an even greater emphasis on differentiation strategies, of which ethics is central.

Ethics goes FAR in federal contracting

Contractors turning to federal contracts for work will discover what many of the contractors we interviewed already know: there are many regulations with which to comply. The FAR document runs to 1,979 pages. Successful bidders on projects over \$5 million must have a code of business ethics and conduct in place within 30 days of receipt of the award. That code must be available to all employees performing the contract, and the contractor must exercise “due diligence to prevent and detect criminal conduct.” The contractor must “otherwise promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law.”

Specifically, ethics and compliance programs must:

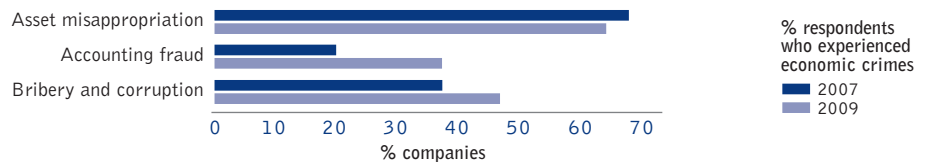
- Establish standards and procedures to prevent and discover wrongdoing
- Provide for periodic risk assessments
- Ensure corrective measures are carried out
- Promote periodic communication and awareness of the ethics code
- Provide an effective training program for ethics education
- Provide and advertise an anonymous hotline for reporting breaches of conduct

It is nearly impossible to establish an acceptable program within the 30-day and 90-day windows provided in the FAR, and guidelines do little to instruct firms on how to go about establishing and enforcing ethics programs. The penalties for violating federal code either under civil or criminal circumstances are steep, including fines, debarment from federal contracts and imprisonment. However, an established “effective” ethics program provides a strong defense against undetected incidents of unethical behavior, and can reduce company liability to nil.

It is clear that the industry has an image problem. In 2004, FMI conducted a survey of 270 owners, architects, construction managers, contractors – 61 percent of survey respondents thought that the industry was “tainted” by unethical acts. Further, there is systemic failure within the industry to prevent unethical behavior: 84 percent reported that they had experienced, encountered or observed construction industry-related acts or transactions that they would consider unethical in the past year.

The 2010 Global Economic Crime Survey published by Price Waterhouse Coopers¹ reported that 24 percent of engineering and construction (E&C) companies had experienced economic crime in the last three years, most commonly asset misappropriation, accounting fraud, and bribery and corruption (see Exhibit A).

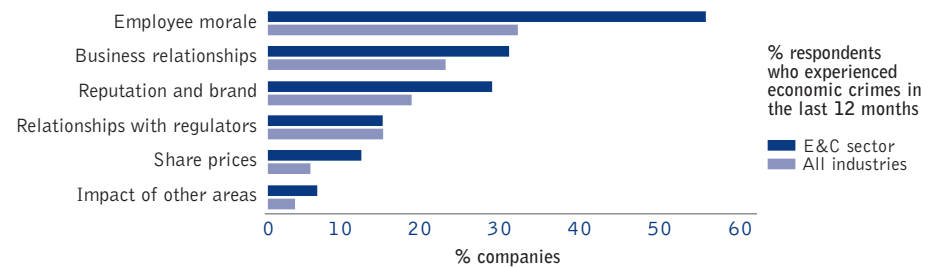
Exhibit A: Trends in reported frauds for the E&C sector



Reproduced with permission from Price Waterhouse Coopers’ “Global Economic Crime Survey: Construction and Engineering Segment.” March 2010.

The findings of Price Waterhouse Coopers also showed that bribery and corruption are more prevalent in the E&C industry than the global industry standard: of all respondents who reported some form of economic crime, 13 percent were impacted by bribery and corruption. Within the E&C industry, that figure grew to 29 percent. Added to the significant financial costs of unethical behavior was an identifiable cost to employee morale: according to findings, morale within the E&C industry is impacted more greatly by fraud than in other industries (see Exhibit B). Clearly, there is cause for countering these issues, both at a human and company level.

Exhibit B: Collateral damage of economic crime



Reproduced with permission from Price Waterhouse Coopers’ “Global Economic Crime Survey: Construction and Engineering Segment.” March 2010.

¹Price Waterhouse Coopers “Global Economic Crime Survey: Construction and Engineering Segment.” March 2010.

FMI spoke with 20 CEOs and compliance managers at leading design and construction firms to establish a picture of the ethics and compliance initiatives currently in practice.

Firms are motivated to implement a formal ethics program by a variety of factors:

1. Company leadership might recognize a need to preserve integrity, honesty, fairness and ethics in the company culture, especially after a period of growth.
2. A firm pursuing federal work must comply with FAR when competing for and fulfilling contracts.
3. A firm has experienced an ethical and/or legal breach, and wishes to insure against a damaged reputation, heavy fines, penalties or lawsuits, and criminal action against employees.
4. Companies identify a vulnerability to unethical behavior through a risk assessment, or find that there is no process or mechanism for handling reports from employees of wrongdoing.

Unethical behavior inhibits healthy competition and impacts the financial bottom line and reputation of the industry. When one contractor takes shortcuts or performs work of poor quality, they put other contractors at a disadvantage, and betray the owner’s trust. Ethical violations also have very real ramifications for safety and quality – use of unspecified materials or shortcuts in procedure can compromise structural integrity in the long-term. There are ways to mitigate unethical behavior. The federal ethics mandate is part of a larger trend toward incorporating and improving corporate governance, risk management and compliance (sometimes referred to as “GRC”). Bill Skelley, human resources director at ColonialWebb, believes an ethics program can offer tangible savings. “One thing you can measure in terms of cost is the number of employee complaints that go beyond our internal resolution processes and result in formal charges. By providing training and counsel to our leaders, we have been able to diffuse potential litigation and the high cost associated with it.” Ethics programs provide a bridge between corporate culture and operational accountability. More than just added red tape, a well-managed ethics program provides an opportunity to maximize your firm’s performance.

Making ethics tangible

FMI spoke with 20 CEOs and compliance managers at leading design and construction firms to establish a picture of the ethics and compliance initiatives currently in practice. Interviewees had in some cases been with the same firm for decades and were associated with long-established ethics programs; in others, they were shaping a relatively new ethics program. It is worth noting that all participants reported ongoing refinement of their corporate policies and practices regarding ethics, and that all had fashioned the associated collateral – code of conduct, code of ethics, employee handbook, training modules, scenarios, etc. – through a largely internal process. Although many aspects of their programs are comparable, each firm developed their own program based on their experience, research and risk assessments, and through trial and error.

Following are a list of best practices FMI has extracted from the interviews.

Ethics starts at the top – the leader must champion ethics policies, practices and attitude.

Mitch Haddon, president and CEO of ColonialWebb, implemented a values system and leadership playbook in 2005 after a period of company growth. The leadership playbook details exact behaviors managers should exhibit throughout the organization, a cue for the entire staff. “Common sense doesn’t appear ‘common’ until you have it written that way,” he explains. “The playbook for leadership behaviors creates the value system at all levels.” To counter the risk of ethics initiatives coming off as simply more bureaucracy, a demonstration of personal investment

Factors like integrity, honesty, fairness and ethics are often a part of company culture in multi-generational firms, but as a company grows, it becomes more difficult to instill those values into the culture.

by leadership can invigorate staff. Granite Construction Inc. had their CEO introduce ethics training sessions to demonstrate that the initiative was important to the company. Doug Woods, president of DPR Construction, is blunt about the importance of leading by example: “If leadership is not committed to something, you know lip service will never make it happen.”

Keep your ethics policy clear, and tie it back to key values.

Factors like integrity, honesty, fairness and ethics are often a part of company culture in multi-generational firms, but as a company grows, it becomes more difficult to instill those values into the culture. Many firms interviewed went about drafting a formal ethics policy that incorporated long-standing values that employees already identified with. Peter Beaupre, president and COO of U.S. operations for PCL, explains the importance of a clear policy. “In the dozens of decisions that each person is making each day, there are many that are made on the spur of the moment by people at all levels of the organization. When they are making those decisions, we want the whole notion of ethics – what is right and what is wrong – at the front of their minds.” Most firms use a combination of a code of conduct, ethics and compliance policy, and annual training to communicate the basics of their ethics program to employees.

Get buy-in from everyone in the company.

Mike Futch, vice president and chief counsel at Granite Construction Inc., emphasizes the importance of driving corporate policy out into the field. “You’re always going to get resistance from people in operations, because they feel it is a soft mandate from management, but you have to convince them that it is everything to do with the project,” he says. Sentencing Guidelines also require continued involvement of the board of a company. “A well-documented board resolution adopting the program and appointing the compliance officer, periodic reporting by the compliance officer to the board or the audit committee with respect to compliance activities, and periodic board training on compliance demonstrate personal investment and buy-in at the highest level of the company,” says Futch. Self-report measures, on-site training and field audits are good ways to promote awareness of ethics on the job site. Many companies get employees to sign paperwork to signal that they have read and comprehended the ethics policy or code of conduct. Dominick Servedio, chairman and CEO of STV, believes that “ethics are critical in our business, and the Code of Conduct is the foundation. You have to live what you preach. There has to be transparency at every level and you have to educate employees before you ask them to sign on the dotted line.”

An ethical culture starts with hiring the right people.

Good corporate parenting is responsible for the strong ethical culture at Sundt. Check references and explore a potential hire’s values on a job application and during the interview. According to chairman and CEO Doug Pruitt, “As you grow and hire and expand, if you bring people from Company X, maybe they have the same training, but maybe they don’t. You’re the one setting an example.” New hires also offer a company an opportunity to build certain values into a generation. “If you already are an ethical company and you’re training the young people who join you in what is expected of them, then when they’re in management roles 20 years from now, it’s completely engrained,” says Jim Moynihan, chairman, president and CEO of Balfour Beatty Infrastructure and Balfour Beatty Rail. Take the next step by implementing mentoring programs to foster a rich understanding of corporate accountability.

Regulations give federal contractors responsibility for discovering and reporting unethical practices within their firms. However, for firms choosing to implement ethics programs at their own behest, accountability is still an important component.

Ethics can be taught.

Many of the games played by various entities on a project can be circumvented by addressing them upfront on the contract or through a partnering agreement. Setting down specific language around change order expectations can limit the latitude a project partner can take. Likewise, addressing ambiguous situations directly can help employees avoid making the wrong decision in the future. Practicing ethical rationalization through scenarios equips employees with the tools to avoid unethical behavior. Says Doug Woods, “Sometimes there is no black and white answer. So you have discussions about those kinds of things and how you might want to be treated, and how you might want to handle the situation.”

Review, monitor and report ethics behavior.

Regulations give federal contractors responsibility for discovering and reporting unethical practices within their firms. However, for firms choosing to implement ethics programs at their own behest, accountability is still an important component. Build multiple feedback mechanisms into your program – an open door policy, hotline, self-report measures, risk assessments, 360° reviews and internal audits are all good components to consider including. Many firms view their hotline as more of a helpline, offering employees the opportunity to ask questions and avoid unethical behavior, as well as report incidents. Update training in response to issues that crop up to insure the firm against repeated violations, and to adapt training to the current areas of risk within your company. “It’s not just a written program, it’s a living program,” says Mike Futch.

Take action on ethical violations.

“We’ve had incidents that we reported to the Department of Justice,” recalls one counsel, “and they’ve been very appreciative, but at the same time they said, ‘You did the right thing, because we certainly might have had that on our radar.’” If a report comes in through the hotline or any other avenue, ensure you have the resources to duly investigate and take action. Many firms start the process by interviewing involved parties or asking for written statements to determine the veracity of the claim. Perhaps the most important determination is whether and at what point to involve legal counsel. If a violation is determined to have occurred, internal or external legal counsel will typically handle the case to preserve attorney-client privilege. Granite Construction Inc. has established a strict Upjohn procedure (after the 1981 Supreme Court decision regarding company privilege) for initiating critical investigations. However, many incidents relate to human resources. Repercussions for violations of the ethics policy should be as clear as the policy itself: suspension, reprimand or termination each have their place. “I learned from people I worked for in the past that nothing was tolerated,” says Jim Moynihan, “and it’s easier if you also don’t tolerate anything.”

Forging the “Integrity Chain”

Many of the firms FMI spoke to had established ethics policies or language well before it was a legal requirement to do so as part of the FAR. Others were contractors who do no federal work, and have no punitive reason to make the significant investment in an ethics and compliance program, but have put one in place. Given the focus on overhead costs at present, what motivated firms to go the extra mile in designing training modules and online courses, and assigning new roles and responsibilities for involved individuals, at significant cost to the firm?

Many firms consider an effective ethics program crucial to their long-term survival.

Ralph James, Ph. D. and director of FMI, introduced the concept of the “integrity chain” in his 2002 book of the same name (see Exhibit C). “One way to understand the importance of the integrity chain is to break the chain,” James said, noting four consequences of poor integrity on business:

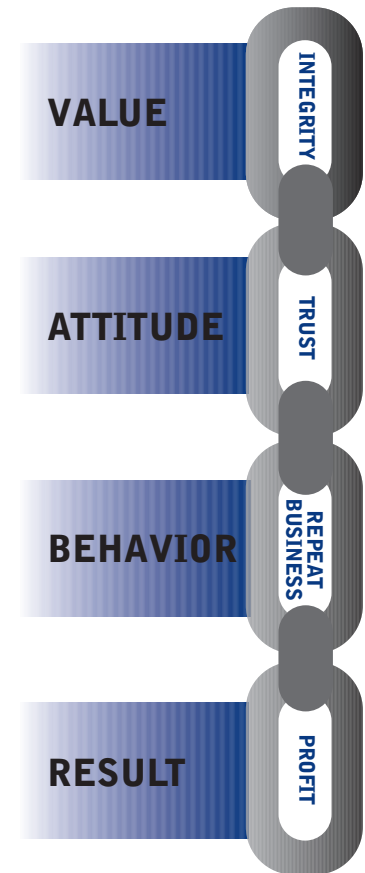
- Increased investment in selling costs
- Increased risk
- Misunderstandings
- Companies have to hide their past²

The design and construction industry is based on trust and repeat clients, so the costs of breaking the integrity chain, of being unethical, can build up quickly.

Several firms stated that they “cannot afford not to” have an ethics program in place; both public and private owners are looking deeply at the reputation of bidders. “Do owners care?” Mark House, chief human resources officer at Beck Group, asks. “Yes. With the transparency of internet and newspapers, ethics are being reported on, and paid attention to.” In a similar vein, Norm Holly, vice president of Kiewit Corporation, asserts that, “It’s not profitable to be unethical. While our safety program has a significant cost associated with it, you can’t afford to have an unsafe project. Neither can we afford to have other than the highest degree of ethics, whatever the cost. Many owners are now going through more than a simple bidding process; they evaluate all aspects of our company and our reputation. Operating within the highest of ethical standards is not only the right way, but is sound business practice.”

Many firms consider an effective ethics program crucial to their long-term survival. “It’s the right time in our industry for this to take off and take hold,” says Larry Cochran, vice president of quality and compliance at Kiewit. “It’s ever more challenging, but it’s absolutely the right thing to do, and part of our sustainability in the long-term.” As firms look to joint ventures (JV), strategic partnerships and new clients to increase their backlog, “integrity” is coming to the fore. “Questionable ethical practices used to be far more prevalent than they are today,” says Tripp Ahern, president and CEO of J.F. Ahern Co. “I think other businesses have become more serious about the code of ethics within their firms.” Dom Servedio argues that ethics are especially important for culture and business at STV. “We rely a lot on JVs, and we have a diverse business, so we have to rely on customers, and it’s a small world.”

Exhibit C: The Integrity Chain



²James, Ralph E., “The integrity chain: The link to profitability in construction.” FMI Corporation. Raleigh, N.C. 2009. (Third Ed.)

While ethics programs can be a stand-alone component of corporate training, it is FMI's experience that the greatest return on investment is realized where the program is embedded in the corporate strategy.

Improving the Image of the Industry

Spearheaded by Norm Holly and Mike Futch, and with the support of the AGC, the CIECI was formally launched in April 2008, following a series of meetings and telephone conferences among legal counsel at several large firms. Formed in advance of, and independent to, the 2008 amendments to the FAR, the CIECI was primarily concerned with improving the image of the construction industry at large and investigating the way ethics and compliance issues fleck through operations and corporate governance. These leaders, and others in the industry, have recognized the importance of ethical issues for the continuance and success of their respective firms. They began their programs with no industry standard to refer to, locating resources within their own companies and building the rest from scratch. Their experiences will help others and their work is setting the bar for standards of ethics programs in the design and construction industry.

“This isn’t just an issue of compliance,” says FMI senior consultant Andrew Patron. “The industry is being incentivized to enrich its culture, to maximize operational efficiency and to develop the current generation into the ethical, informed leaders of tomorrow.” Those interviewed agreed that an ethical reputation was crucial for attracting young talent, keeping repeat clients and pursuing strategic partnerships. If customers do not require bidders to have and abide by an ethics code to compete for projects, why would a contractor spend precious resources to create and maintain an ethical program? The short answer is that many do not. That does not necessarily make those companies unethical. It means they have yet to understand the business need to institute an ethics program.

For firms looking at developing an ethics program, some questions to ask include:

What are your firm’s core values?

- How is your firm’s culture reinforced with those in the field, or with new recruits?
- Would you be able to identify ethical breaches if they were occurring in your firm?
- What lines of communication are open to employees with feedback? What anonymous avenues are there?
- Have you changed on-boarding or annual training programs significantly following bouts of company growth?
- How might ethics tie into existing corporate priorities like leadership, corporate governance, compliance or risk management?
- Have you conducted a risk assessment recently? Do you know where your company’s vulnerabilities are?
- Looking at your key competitors and clients, can you afford not to have an ethics program?

While ethics programs can be a stand-alone component of corporate training, it is FMI’s experience that the greatest return on investment is realized where the program is embedded in the corporate strategy. A program that calls attention to company goals, clarifies the company’s direction and issues clear directives for staff can be galvanizing, especially during times of thin backlog and low morale. The integrity chain established the connection between profit and integrity, through the relationships that constitute the design and construction industry and result in repeat business and, ultimately, profitability. Now more than ever, your reputation impacts your bottom line. Now is the time to focus on ethics within your company.

For more information on how FMI can help you tackle the challenges facing your firm, please contact: **Andrew “Andy” Patron**, Senior Consultant, at 919-785-9239 or apatron@fminet.com

Andrew Patron (Andy) is a senior consultant with FMI, management consultants to the design and construction industry. He specializes in the creation and implementation of training programs, which are designed to develop world-class leadership and organizational effectiveness. Andy's enthusiastic approach draws from his real-world experience in management and the construction industry. Andy brings with him over 20 years of experience working with private and public sector owners and contractors.

As a production manager in the residential market, he has been responsible for the day-to-day allocation of resources and learned to tackle the unique operational challenges associated with production in the construction industry. Andy has worked on national and international projects for a Fortune 100 information technology company. Andy brings this industry experience to every talent development program he delivers to provide relevant and practical solutions for our contractor clients. He holds a Bachelor of Science in Industrial and Operations Engineering from the University of Michigan in Ann Arbor.

Andy and the FMI research team would like to thank the Associated General Contractors of America, Construction Industry Ethics and Compliance Initiative and all interviewed parties for their participation in this study.

About FMI

FMI is the largest provider of management consulting, investment banking and research to the engineering and construction industry. We work in all segments of the industry providing clients with value-added business solutions, including:

- Strategy Development
- Market Research and Business Development
- Leadership and Talent Development
- Project and Process Improvement
- Mergers, Acquisitions and Financial Consulting

Founded by Dr. Emol A. Falls in 1953, FMI has professionals in offices across the U.S. FMI delivers innovative, customized solutions to contractors; construction materials producers; manufacturers and suppliers of building materials and equipment; owners and developers; engineers and architects; utilities; and construction industry trade associations. FMI is an advisor you can count on to build and maintain a successful business, from your leadership to your site managers.



MANAGEMENT CONSULTING • INVESTMENT BANKING
for the ENGINEERING and CONSTRUCTION INDUSTRY