Business Ethics, Risk Management, and the Open Enterprise

By Mark W. McElroy

When I was Board Chair of the Sustainability Institute about two years ago, someone once asked me what our *theory of practice* was. I said that by exposing leaders in business to the drivers and dynamics of organizational behavior, and to the unwanted outcomes that sometimes follow, we believed we could help them lessen their organizations' damaging impacts on society, the environment, and themselves. In other words, we believed that by showing them these things, we could compel them to adjust their behaviors and to avert unsustainable outcomes, simply because they'd see the error of their ways and would be moved to change them.

Two years later, I no longer believe in this theory. In fact, I think it is false in the sense that the practice it leads to is superficial and (ironically) ethically neutral or maybe worse. Why? Because it treats only the symptomatic expressions of illicit and unsustainable behaviors in business, but not their cause. I now believe that the real disease is not just the dynamics of business behavior as I thought before, but that the problem goes much deeper than that. Thus, much of what passes today for best practices in Business Ethics and Sustainability Management may be missing the mark. How so, you ask?

By now, the pattern of concern to all of us in such cases as Enron, Worldcom, ImClone, and the rest is clear: Managers with questionable ethics sometimes make bad decisions. Before, during, and afterwards, they occasionally encounter resistance to their plans from peers or subordinates. Such challenges are often suppressed or swept aside by managers, and knowledge of the offending ideas (and those who oppose them) becomes hidden from view – *even from board members*. Worse yet, people get fired, transferred, or otherwise punished in the exchange, merely for expressing their dissent.

The field of Business Ethics has an obviously important role to play in our collective response to the epidemic of corruption and malfeasance in corporate America. But is it one that should be aimed only at the business decisions or processes we seek to repair or control? I think not. Indeed, what good does it do to confine our interventions to only the range of behaviors we seek to constrain (e.g., to our accounting practices and such) if the underlying conditions that enabled them to emerge in the first place go untouched? Aren't the same conditions liable to produce new offenses yet again in the future? Shouldn't we be looking to correct the origins of illicit behavior, and not just their latest effects?

The Ethics of Knowledge Processing

There is another dimension to ethics in business that screams out for attention here – another level of organizational behavior, that is, that lies at the base of things. The issue I speak of here is the nature of 'knowledge processing' in business, and the extent to which it is either 'open' or not. What do I mean by this?

Look at it this way: At Enron, Worldcom, and the others, two things happened that should concern us. First is that illicit and unethical business decisions were made under the authority of senior managers. This was wrong and was clearly a breach of ethics – even illegal. Second, and quite separate, was that (a) such illicit ideas were able to get as far as they did *before* they were implemented, and (b) that when related plans were rightfully challenged by peers or subordinates, their objections were quashed by the system – *the knowledge processing System,* that is. Ideas that clearly should have been treated as *dead on arrival* somehow managed to survive repeated challenges to their legitimacy. It is this second concern that I speak of here – *a breach in the safety net of open debate, and* *in the freedom of employees to engage in thoughtful without fear of retribution!*

Indeed, this goes beyond bad decisions being made by unscrupulous managers. This is a more insidious disease – a cultural one – found at the level of the enterprise itself. But here, it's not so much a breakdown in the execution of business processing behaviors as much as it is a failure of the *separate* processes businesses rely on to develop, test, evaluate, and integrate their knowledge. *There is a difference between making and enforcing decisions, and making and enforcing knowledge.* The first is a management process that entails commitments to action, whereas the latter is an organizational process that entails commitments to beliefs. They can and should be separate; the former need not constrain the latter (see Figure 1).

Thus, it should be possible – and it *is* possible – for managers to make and enforce their decisions even as discussions about them (their decisions) and openly take place in parallel. Where we get into trouble is when managers who clearly 'own' decision making authority improperly constrain corporate conversations as well, and who thereby subvert the rights of well-meaning (and entitled!) employees to openly discuss or disagree with the ideas held by those who happen to set and enforce strategy, and to have such discussions without fear of retaliation.

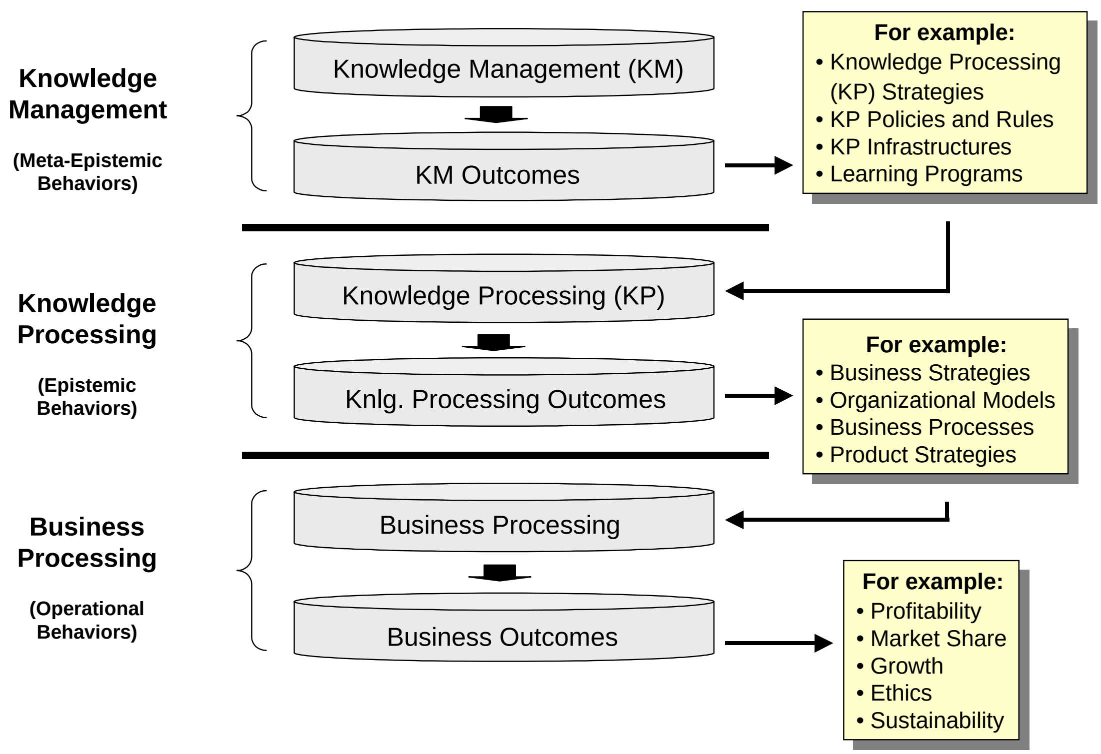

Figure 1 - Three Levels of Behavior in a Firm

Let's face it, sometimes management's decisions are wrong. And, yes, sometimes they're right. But discussion is not disobedience or even insubordination – it's just discussion. And it has the effect of improving the quality of our ideas, not the reverse. This is what we want for our ideas, isn't it – better quality?

We can say, therefore, that the suppression by management of open and rational criticism of their own ideas, policies, and decisions in an organization is unethical. Why? Because it puts management's interests above those of the organization in two important ways. First, it has the effect of shielding (or hiding) managers' ideas from criticism, which is especially worrisome in cases involving unscrupulous actors. Second, it undermines the interests of other stakeholders in a firm – be they employees, owners, or surrounding communities – by prejudicially marginalizing them from the knowledge processing affairs of the firm, as if their ides or stake in the organization lack sufficient standing. To be sure, the quality of organizational knowledge improves, as does the well-being of its constituents, when it is produced, tested, and evaluated in the bright light of day.

When managers short-circuit this process, they not only damage an organization's basic capacity to adapt, they also deprive its stakeholders of information concerning their own vital affairs. Moreover, external stakeholders become cut off from debates about actions being taken by management as seen from the invaluable perspective of insiders. Indeed, when disputes arise regarding the legality or ethics of policies held by management, stakeholders are absolutely entitled to know about it and to openly discuss it.

Democratizing Knowledge Processing

Does it necessarily follow from all of this that management in organizations should be democratized? I think not. Rather than argue for the democratization of management or decision making in business processing, it argues for the democratization of learning and knowledge making in knowledge processing (again, see Figure 1). Managers can continue to manage at the level of *business processing* without undue interference and to commit firms to action, even when their ideas are being openly debated at the level of *knowledge processing*. Transparency and inclusiveness in the latter does not at all require abdication by managers of the former.

Still, there is no doubt that when serious errors in business judgment occur, a proper remedy is to specify new rules, policies, or procedures for the business processes of interest. But with Enron and the rest, the problem went deeper than that – it wasn't just about *inadequate accounting rules* or *unethical managers*. The deeper issue was the extent to which knowledge held and enforced by managers in those firms was open to constructive and/or rational criticism by any or all of its stakeholders – *or not* – and not just to those who happened to occupy positions of leadership.

As I say, there is a difference between decision making (the undisputed province of managers) and knowledge making (the rightful province of *all* stakeholders). The exercise of authority in the former should not preclude openness in the latter. What I'm talking about here, then, is whether or not an enterprise is truly 'open' in terms of the level of transparency and political inclusiveness that exists in the conduct of its knowledge processing affairs.

Indeed, the knowledge processing affairs of business should no longer be regarded as the private totalitarian domain of managers. Rather, knowledge processing 'belongs' to all of the stakeholders in a firm, and is a kind of *social capital* that no individual or group is entitled to own, restrict, or control. It transcends, therefore, managers and their designates. Moreover, all attempts to co-opt or suppress it are arguably unethical because they deprive an organization (and its stakeholders) of their very capacity to learn, adapt, innovate, to protect their own rights, and to avoid infringing on those of others. Our ability to learn is vital to our survival and no one has a right to subvert it. *Thus, maintaining the quality and integrity of knowledge processing in a firm has clearly become an ethical and a fiduciary issue – a new duty of boards and their managers in the twenty-first century!*

So, in addition to the usual prescriptions for Business Ethics in organizations, board members and their managers should now *also* be taking steps to establish policies and programs designed to maintain openness in knowledge processing. A promising new model for this, *The Open Enterprise*, was recently developed by the Knowledge Management Consortium International, a professional association of Knowledge Managers, consultants, and academics from around the world. The Open Enterprise framework specifies the dimensions for policies and programs that together define an organization's 'Knowledge Operating System' – its *knowledge processing* environment, that is. But while all organizations have Knowledge Operating Systems, not all of them are open – or as open as they should be.

The computer metaphor I use here is quite intentional, for how can we expect interventions aimed at correcting errors detected at the level of business processes (the analogue to software 'Applications' on a computer) to prevent similar problems from arising yet again on other fronts, if the root problem itself lies at the lower level of the (Knowledge) Operating System? The answer is 'we can't.' What we need, then, are solutions aimed at *both* levels – Business Processes and Knowledge Processes.

That said, it's arguably the Knowledge Operating System that matters most, because it's the Knowledge Operating System that governs the manner in which corporate knowledge is produced, tested, and evaluated before it shows up in practice. Bad Knowledge Processes too often lead to bad knowledge, which in turn, when practiced, leads to illicit action and unnecessary risk. These processes too, then, can be quality-controlled, and it is the new, urgent fiduciary duty of Business Ethics officers, Risk Managers, and the boards they report to, to do so.

Organizational Implications

What does all of this mean from an organizational and operational perspective? First, it means that boards should assume a stewardship position with regard to knowledge processing and its quality, because the quality of knowledge processing has become a significant risk factor in business. Second, because of this, boards should assume control of the Knowledge Management function. Why? Because the purpose of KM is to manage the quality of knowledge processing, and if the latter is arguably a board-level concern, so should the former be.

Indeed, that *Knowledge Management* is evolving into a form of *risk management* is becoming increasingly clear. Three new books, in particular, offer vivid testimony to this, including one co-authored by myself and Dr. Joseph M. Firestone entitled, *The Open Enterprise – Building Business Architectures for Openness and Sustainable Innovation* (KMCI Online Press, 2003). The other two, *The Naked Corporation*, by Don Tapscott and David Ticoll (Free Press, 2003) and *Managing Corporate Reputation and Risk*, by Dale Neef (Butterworth-Heinemann, 2003) also argue persuasively for a new focus in management that Firestone and I call *Transparency Management*.

In *Managing Corporate Reputation and Risk*, Neef goes so far as to say that *"a company can't manage its risk today without managing its knowledge."* And since managing risk is arguably a fiduciary duty of corporate boards, Firestone and I believe that guarding the sanctity of knowledge processing has become a board level issue – a view that says KM should exist outside and above the control of the executive function and the sub-functions that lie beneath it.

For all of the same reasons we look to boards for oversight in financial management, so should we look to the same boards for oversight of *Knowledge Management*. To place the responsibility for ensuring the integrity of knowledge processing anywhere else is to invite conflicts of interest between the duties of those who would *have it* and their own behaviors. Financial management and Knowledge Management both require independent oversight and should report to the board accordingly. But how, you ask?

Recently, the Institute of Internal Auditors (IIA) published a recommended reporting structure for financial management and internal auditing (see Figure 2). According to the IIA (in its response to the Sarbanes-Oxley act), every board of every publicly traded company should have an audit committee to which the internal audit function directly reports along with external auditors.

My colleagues and I at the Knowledge Management Consortium International (KMCI) propose a similar structure for KM (see Figure 3). According to our view, KM should oversee, manage, and enhance the quality of knowledge processing, while

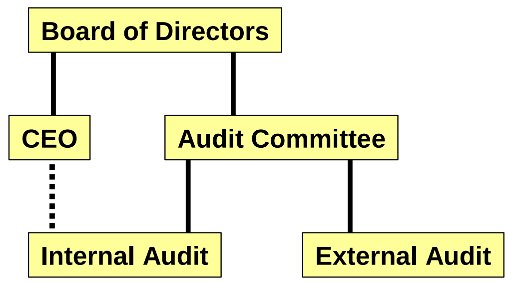

Figure 2 – Model for Financial Reporting and Control
As Proposed by the Institute of Internal Auditors

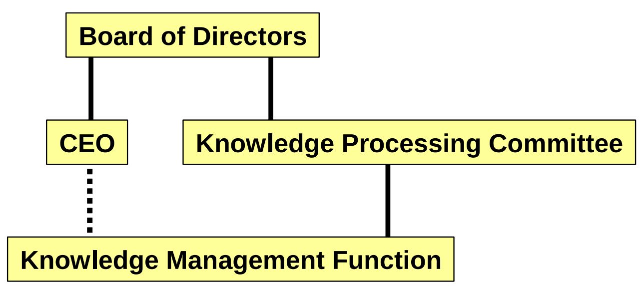

Figure 3 – Model for Corporate Knowledge Processing
Control As Proposed by the Knowledge Management
Consortium International (KMCI)

ensuring the system is sufficiently open and transparent. And because maintaining the integrity of knowledge processing is important to the protection of shareholder value, we believe Knowledge Management should report directly to the board, and only indirectly or administratively to the CEO.
All of this argues for a more broadly defined Risk Management function in business, some elements of which, if not all, are clearly board level issues. In this regard, then, managing corporate knowledge processing should be seen as a form of Risk Management, very much akin to the treatment of concerns related to social responsibility, sustainability and the environment, employee and product safety, quality, regulatory compliance, audits, governance, and ethics.

In the end, excelling in Knowledge Management may very well be the strategy that matters most in business, for if behavior in organizations is nothing more than individual or shared knowledge in use, everything else pales in comparison to the urgency of enhancing the quality of knowledge processing – performance and outcomes of all kinds depend on it. Thus, knowledge and risk management are inseparable!

Conclusions

We can conclude, then, by pointing out that closed or constrained Knowledge Operating Systems are undesirable and unethical because they too often support the production and practice of illicit ideas, plans, policies, strategies, and other forms of (unwanted) corporate knowledge, while depriving others of their ability to learn. Worse yet, they make it possible for the constructive rational criticisms of well-meaning employees and other stakeholders to get lost or suppressed in the exchange, often under the dark hand of coercion and the threat of retribution. All of this lies beneath the merely superficial, visible business-level behaviors we so often lament. But it is no less deserving of our attention – it is *more* so – and it is no less unsustainable.

We can also conclude by agreeing that if the quality of knowledge processing in an organization has become a fiduciary issue – *and it has* – then managing the quality of knowledge processing (i.e., Knowledge Management) should report directly to the board and only indirectly, if at all, to the executive suite. Action in business is nothing more than knowledge in use, and if the action taken by managers and others in business is to be properly governed by directors, then knowledge processing must report to them and nowhere else.

It should be clear, then, that from now on, *no Business Ethics program, Risk Management strategy, or governance scheme should be viewed as complete unless it contains a prescription for openness in knowledge processing with direct ties to the Knowledge Management function. And all of that, in turn, should report to the board.*

This is the new vision of the Open Enterprise, models and methods for which now exist. Using them judiciously can go a long way towards helping organizations *kill their worst ideas before their worst ideas kill them (or us)!*

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About The Author

Mark W. McElroy is president and CEO of Macroinnovation Associates, LLC in Windsor, VT and Co-Director of the Knowledge Management Consortium International (www.kmci.org), a division of the Center for the Open Enterprise. He is Board Chair Emeritus of the Sustainability Institute in Hartland, VT, where he also lives. Mark is a co-developer of 'The Open Enterprise' model, and is co-author of a related book with Joseph M. Firestone entitled, *The Open Enterprise – Building Business Architectures for Openness and Sustainable Innovation* (2003). He is also author of *The New Knowledge Management – Complexity, Learning, and Sustainable Innovation* (Butterworth-Heinemann, 2003). Mark is a 26-year veteran of management consulting, having spent much of that time at such firms as Price Waterhouse and KMPG Peat Marwick, where he was a partner. Mark can be reached by e-mail at mmcelroy@vermontel.net.