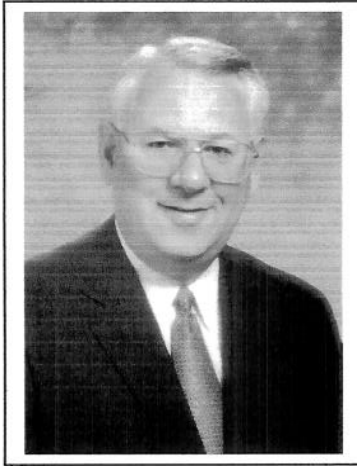


Executive Interview



Implementing Ethics in a Corporate Environment: A Conversation with Steve L. Scheck

Vanessa Hill
J. Brooke Hamilton III
Mark Smith
University of Louisiana at Lafayette

Executive Summary

There has been an ongoing discussion regarding the proper placement of the ethics office in the corporate structure. Often, the ethics officer is a designated staff position: part of the HR component, located in a separate Ethics Office, or a member of the legal department. All of these configurations have the ethics officer serving in a staff rather than line position and operating in an advisory capacity.

ConocoPhillips decided to place the office in the audit and finance area. This placement locates the ethics function squarely in an operating division of the firm whose purview extends into all other areas of the corporation. We had the opportunity to talk with Steve L. Scheck, General Auditor and Chief Ethics Officer for ConocoPhillips, regarding the processes for implementing ethics and compliance. Scheck described how the Conoco President's Awards based on core values have carried over into ConocoPhillips. He discussed the firm's approach to conducting investigations of ethical violations and emphasizes the value added of combining this function with general internal auditing.

Scheck was born in 1949 and grew up in Arkansas City, Kansas. He attended the University of Oklahoma and East Central State University where he graduated with a bachelor's degree in accounting in 1971. Scheck began his career with Conoco in 1972 in the finance department in Ponca City, Oklahoma. After serving in a variety of domestic and international positions, Scheck moved to the corporate office in Houston in 1991 and has held senior management positions in the company's upstream, downstream and corporate finance groups. In 1996 Scheck became general auditor of Conoco and in 2002 was named general auditor and chief ethics officer of the merged ConocoPhillips operations.

Authors: In a previous conversation, ConocoPhillips' former chairman, Archie Dunham, told us that the President's Awards were an important element in creating an effective

ethics culture at Conoco. Did these awards continue to play the same role at ConocoPhillips after the merger?

Scheck: While we changed a little bit in what we call it and how we do it, we still have the ethics award at Conoco/Phillips. You go around the company today and people still have the ethics awards that we gave them at Conoco. The people and teams still proudly display them in their offices. I've got one of the prototypes here. Today, we call this award the Spirit Value Awards. Integrity and ethics are among those values. We have a process to nominate, review, and award. We have a huge event in February where we bring together all of the award winners and several layers of management. There are probably three or four hundred people at the gala dinner, and there is a reception beforehand. There is a video of each award winner. Each one of the winners is brought up on stage to receive their award from one of the management committee members. It is embedded in the new company. We didn't have to fight or push to get that done when we merged the two companies. It was something that came naturally for both companies.

Phillips had something known as the Shield Award, which is the old Phillips 66 Shield; we had the President's Award. We put them together because it was a merger of equals. Rather than call them one thing or the other, we called them The Spirit of Performance Award because we built our company around the word "**Spirit**" and the acronym that it stands for ("**S**afety" "**P**eople" "**I**ntegrity", "**R**esponsibility" "**I**nnovation", "**T**eamwork").

Authors: That's nice to hear. I heard that one of the reasons that Phillips had sought the merger was because they saw real value in Conoco's culture and wanted to merge with a company like that.

Scheck: We formed seven integration teams and each team had a leader from a heritage company (Conoco or Phillips). Our job was to establish for the organization what the policies and procedures were and to staff the organization. For the integration of the global finance function, I was the lead from Conoco and the vice president and controller was the lead person from Phillips. We worked between 18 to 24 months to build the finance organization globally. It had to be linked to the business operations, policies, procedures, and legal requirements.

I don't see a lot of difference in the cultures of the two heritage companies. Maybe the performance results were a little different. Phillips was close behind us when it came to the environment and safety. But in terms of other performance goals we were very much compatible. It really was a merger of equals. If you walk up and down this hall today, unless you know which side somebody comes from, about the only way you can tell is from the memorabilia in their office. If you are in a conference room you can't tell who comes from which side; which is good. It is two years into the merger, and it has been that way for a year.

Authors: That's a successful merger.

Scheck: Well we think so, and the results are starting to tell in what we have been able to accomplish. We've paid down the debt and the stock prices are continuing to grow. We are in much better position to compete for projects than we were before because our risk tolerance is a bit higher.

Authors: In what way is your company working to meet the ethics and compliance requirements of Sarbanes Oxley and the Federal Sentencing Guidelines?

Scheck: We have always had very strong controls, but there are areas where we found that we needed to shore up a few things. Some people think it is increased work but it is really going back to basics—what we needed to be doing all along.

Authors: Is there a benefit in that these regulations require strong controls so that it is easier to justify the budget for ethics and compliance?

Scheck: I think it makes it nondiscretionary. Many times under the pressure of getting things done on a Monday through Friday basis, some things tend to get deferred. Sometimes people take the attitude of “I’ll get to that next month.” Under this process you really can’t do that. It heightens the importance of controls on a daily basis, which is fine. It makes our life a lot easier from an audit standpoint for sure.

Authors: Are you familiar with the provisions in the new Federal Sentencing Guidelines that state that companies have to identify any incentives that encourage people to do the wrong thing? Have you done any planning to comply with this provision?

Scheck: We have done that for a long time. We have looked at things like our trader bonus programs. In our standard compensation programs, any kind of variable compensation, we check to insure that there are no means to get a higher award for unethical behavior. Most of our programs are reviewed by the compensation committee as well. So we feel pretty good about it.

Authors: Does compliance with the new regulations also involve looking at the organizational structures and systems in place? Do you evaluate how they may put undue pressure on employees to do things that are unethical in order to meet goals?

Scheck: Yes, some of it does. Part of our normal audit programs are “tone at the top” and separation of responsibilities. Just about every audit we conduct examines this, so it is not a new thing at all. And when we put the two companies together—Conoco and Phillips—we took some specific hard line stands. For instance, the fact that we require our support staff for our supply and trading group to report directly to central finance. They do not report up through that business unit simply to have some separation of that responsibility. That way, a trader cannot go down to the back office and lean on the support staff. That way the people keeping the accounts have an outlet to go to. So this provides separation of responsibilities.

Authors: You have the dual titles of general auditor and chief ethics officer. Why did ConocoPhillips decide to combine these two functions?

Scheck: Well I thought a little bit about that. I wish there was a bolt of lightning that I could give you to say, “This is it.” You could make the chief ethics officer either the general auditor or chief general counsel. I think the important thing is to make sure it is one or the other and not relegate it to a staffer. I take the role of chief ethics officer personally. I think you have got to

have somebody senior, somebody experienced, and somebody that people trust. It is a big responsibility. You can't have someone in that position that has a reputation for always pushing the envelope. If you put that kind of person in charge of ethics I am not sure that the system is going to work. While this is a big company with operations in 40 countries around the world and 36,000 employees, they know I am the chief ethics officer. I think that they respect me or they respect the position. When I go someday they will be watching who replaces me in this job.

I think that confidence in the ethics officer depends on the kind of experience he/she has as well. I have worked in all segments of the business; I've worked overseas, I've worked domestically, and I've worked in corporate. You have got to have someone in this job that understands the operations and how things get done. He/she must also have the confidence, respect, and trust of management. The organization must respect the position and the person in the job.

Authors: What about the protection for the person in that position?

Scheck: If you are worried about protection, you probably should not be in the job. I report directly to the audit committee. The charter for the ethics office in the company's audit area states that I report directly to the audit committee.

Authors: So you report to the board of directors rather than to top management.

Scheck: I report to the chairman of the audit committee who is a member of the board of directors. We review my charter every year and it's signed by the chairman of the audit committee, the CEO, and the chief financial officer. It says in the charter that I report to the audit committee. Now you can't use that as a ball bat and go beat people up with it. I've never had to use it with management—they understand that. But I've got to have an outlet in the event that anyone would come to me and say, "We're going to do this, and I want you to look the other way." I have to be able to say, "I can't do that."

One of the things we have always had is an ethics hotline and we continue to have it. It is very robust and well communicated. It's not just a paper program, it is actually used. Last year, we had over 700 calls to the ethics hotline. Since the merger, we have downsized our service station network significantly. A lot of those calls were about employment and compensation issues with service station employees. This year, to date, we have only had about 130 calls.

One of the things that we use that hotline for is to comply with Sarbanes Oxley's whistle blower requirements. Anytime that we get a call that has to do with accounting, auditing or financial reporting issues; the first thing I do is pick up the phone and call the chairman of the audit committee. I do that before I talk to management about it. I'll say, "We've got an issue and here is what it's about; here's how we're going to propose to deal with it," to get him on board. He might want to have a special meeting, but typically he doesn't and he will say, "Let's brief the full committee at the next meeting."

Authors: How often do you have face-to-face meetings with the board?

Scheck: We have six meetings a year where I report activities of the ethics office. I report at each one of those six meetings. I show them the statistics from the ethics office, any whistle blower calls, and I report all of the investigations we do. They are very engaged and knowledgeable about any fraud or ethics issues in our company. Then we engage management and go about doing our job, investigating it and closing the file. All of those things contribute to an ethics culture.

In addition, Conoco-Phillips distributes ethics reminders periodically. We emphasize a section of the ethics code, whether it's about gifts and favors, conflicts of interest, intellectual property or whatever. Then I issue a brief e-mail to all employees; it comes from me. It says "be reminded that here is our standard." It's amazing how many people come back and say, "Well okay, I read that and I've got a question about what I'm doing." Twenty percent of the calls we get through the ethics hotline are requests for guidance. They're not all allegations or "I'm confronted with this situation." The statistics are a little bit skewed to the high side unless you take out the requests for help.

Authors: How do you identify areas of vulnerability for ethics problems?

Scheck: Our auditors are always out in the field. They get questions and they bring them back. If we see a trend in topics, we track them. One of the things I carry around with me is the tracking system. This is my tracker for ethics. [At this point, Scheck opened a three-ring binder filled with color coded forms.] This is through July; we organize the allegations by category. We label the allegations as business practices, compensation, employment issues, or whatever. We also break them out by how the call came in as well as which area of the business it came from. We also track which ones are allegations or requests for guidance. I show the tracking report to the audit committee every time we meet. This way they know what (business) areas the issues are coming from. It helps us decide if we have an issue or if we have any trends and where we might need to do some more training.

Authors: Do you think it helps that the ethics function is connected to the traditional internal audit function?

Scheck: Yes. It is because people know that like the internal auditor, the ethics officer reports to the board. It is critically important for ethics to have that same force, as the internal audit. My charter says that I can go and my staff can go and look at anything in the company. We have free and unfettered access to anything in the company. That's important from an ethics standpoint. I go to meetings with other general auditors, and they're envious because they only know what somebody tells them. I can take the results of the ethics work and very easily put it into my risk assessment. I use this to formulate my overall global risk assessment and the risk assessment for a particular project. If ethics complaints were buried in another department as they are in other companies there is often a shroud of secrecy around that activity that my counterparts would not get information on.

Authors: So you are saying that both the ethics and the audit functions benefit from being combined?

Scheck: I can evaluate “tone at the top” better with this structure. I have more responsibility for ethics than most of my peers do. We can see the trends that are in a business unit or functional area. We can also see the kind of calls we are receiving. Usually, the calls are pretty explicit, “John Doe, my boss said that I can’t do this, and that flies in the face of policy.” I know who John Doe is in that context and whether he is a senior manager, middle manager, or front line manager. And through our investigative work we try to be probative as to whether this ethical issue is systemic of that entire management chain or is just an individual who misunderstood a policy. So because of our connection to audit work, I’ve sent auditors out to look at an area and I’ll call the lead auditor in and say to watch for this ethics issue. Being able to do this is invaluable.

Authors: I guess one thing you can say is that internal auditing is taking place all of the time, so it’s not like having a special ethics police.

Scheck: Yes, although in today’s environment we don’t go every place all of the time. I wish I had enough people to go every place all of the time, but we are a risk-based organization so we cream the risk curve in terms of where we go. But if we get a complaint or allegation on the ethics line, we look into it regardless of risk. We look into every one of these things, and I think that’s critically important. It is important to have an ethics officer who will investigate every call. He can’t say, “Well I heard about that, somebody told me that at the ball game the other night; but I know that guy and that could never happen.” This must not happen—every one of these allegations has to be investigate fully and you have to satisfy yourself that either there is something there or there’s not. The real challenge comes when you start getting multiple calls about the same thing and you’re not finding anything. That’s the real challenge. So you start digging a little deeper and typically where there is smoke, there is fire; especially when you get multiple calls. If nothing else it’s a “tone at the top” issue. We’ve had a couple of those and we’ve reviewed and removed managers. In one case, the manager came back and said “You know, I thought you guys were mistreating me, but I understand now what I was doing wrong. You made my life a lot easier because I was in over my head and I was stressing out and I was not doing things right.”

Authors: When you find something going wrong, you report to the board but you probably don’t take everything to the board. What is the actual mechanism for deciding when to involve the board?

Scheck: You have got to use your judgment. If it is an allegation, typically we go directly to management. Then again that depends on what kind of allegation it is. If it is somebody who says, “Well I didn’t get paid for overtime last month because I had this personal situation” we don’t take those to the executive vice president. We’ve set up a network of people to help deal with these ethics calls. We send that to a general manager of HR and he/she will get with the compensation benefits people and look at that situation. He will get with operating management or HR and they’ll review that situation and come back to us. We’ll send out a closure report; stating what the allegations were, what was done and then they come back and we close the file. I review those and if I don’t think that they have done enough I’ll send it back to them. I have a couple of senior people and they know how to do these things. They have an established track record on this.

On the other hand, if it is a senior manager or if it is a potentially explosive situation—by which I mean big dollars or an allegation of inappropriate accounting, auditing or financial reporting—I will call the audit committee chair immediately. He may say, “Let’s have a conference call with the rest of the committee members, I’d like for you to brief them on that.” Or, he may say, “Go ahead and proceed and let’s update the committee at the next meeting.” I have an executive session with the audit committee at every meeting. This is unique. A lot of my peers do not have the opportunity to have an executive session where it’s just me and the five audit committee’s members.

Authors: That is opposed to having to go before the entire board?

Scheck: Yes. I’d rather not do it in open session with other company managers around the table, whether it’s the CFO, the controller or the general counsel. They usually sit in on the audit committee’s meetings, but it’s just me and the audit committee for the executive session. They start it very visibly where they say, “Steve you stay, everybody else out.” A lot of my peers say they get this opportunity once, maybe twice a year. My committee expects it at least five times a year.

Authors: The message they are giving you is that they really want to know what’s going on.

Scheck: There’s no question about it. In fact, my expectation is that they would counsel me if they heard about an ethics or an audit issue from someone else besides me. You may have read the Plaquemines Parish sheriff’s report. You probably saw that several Conoco/Phillips’ contractors were indicted by the FBI for stealing from our Alliance Refinery.

Sure enough, we had a contractor who was carrying some expensive warehouse parts out of the refinery and selling them on the black market. We conducted an investigation with security and turned this over to the FBI because they were selling across the state lines. These contractors are now under grand jury indictment, and they will probably go to jail over it. You don’t want your board members reading that for the first time when it hits the media. Then board members call me saying “Steve, were you asleep?” So I make sure the board knew about it as soon as I knew about it. The first call I made was to the chairman of our audit committee. Even if I didn’t have all of the facts, the allegation was there. I told them, “Here is what we know and here is our plan of action.” Then the chairman makes the decision, and in some cases he will send an email to the entire board or phone. Luckily, we don’t have this on a regular basis. But we are a big company and have operations in a lot of difficult areas around the world.

Authors: How far will you go to enforce company policy?

Scheck: A good example of that is the audit we did last year of our email traffic—appropriate and inappropriate use of email. We terminated 24 employees, and we asked 17 contract employees to be removed from our premises. That assures us that we will not have some of the problems other big companies are having. Good policies are a lot easier to administer than shades of gray. We have a zero tolerance position regarding unethical behavior.

Author: Could you conclude with a summary of what you see as the future of auditing and ethics in your industry?

Scheck: Well, I can tell you that it's getting a lot more attention from boards. This area is getting much more scrutiny by audit committees. I'm not sure if it's more than it should be, but it's certainly more than it was in the past. Board members are taking their jobs very seriously. If they are not spending more time in committees meeting with internal and external auditors and ethics officers, then they are not doing their job. I think that trend will continue. I think once you create an expectation with your employees that it's okay to call that ethics line—then a lot more of them will call. Employees begin to feel comfortable and won't feel the need to remain anonymous. I think you'll see more and more of our industry joining the audit and ethics groups together. Simply because it just makes good sense. There is efficiency and effectiveness that could come from joining the groups together.

About the Authors:

Vanessa Hill (Ph.D., SPHR) holds the Bank One Minority Professorship in Business Administration and is an assistant professor of management in the Moody School Business, University of Louisiana at Lafayette. She earned an MSIA and Ph.D. from Carnegie Mellon University. Her research interests are organizational culture, leadership, and social issues in management. She has worked with community and private organizations providing consulting services for culture change, ethics, diversity, compensation and training practices. Her publications appear in *Southern Business Review*, *The Diversity Factor*, and others.

J. Brooke Hamilton III (Ph.D.) is Burdin Professor of Professional Ethics and associate professor of management in the Moody School of Business, University of Louisiana at Lafayette. He was head of the philosophy department at Tuskegee Institute, worked 14 years as marketing vice president for Elks Concrete Products, Inc., and returned to teaching after completing his MBA in 1990. A consultant in business and clinical ethics, his publications appear in *Business Ethics Quarterly*, *Journal of Business Ethics*, *Professional Ethics*, *Case Research Journal* and others.

Mark Smith (Ph.D.) is E. P. Nalley Professor of Management in the Moody School of Business, University of Louisiana at Lafayette. He has an M.B.A. from Harvard University and a Ph.D. in business policy from the University of Washington. His interests lie in business policy, strategy, economic development, and supply chain management. His publications have appeared in *The Administrative Science Quarterly*, *Personnel Psychology*, *Strategic Management Journal*, *Case Research Journal*, and others.

The idea for this interview came from one of the author's three years as a member of Conoco's award selection team for the President's Award for Business Ethics. For further information about Conoco's ethics culture, see Hamilton, III, J.B., Smith, M.S., & Scheck, S.L. 2002. Conoco's Decision: The First Annual President's Award for Business Ethics, *Case Research Journal*, 22(3), Summer 2002, 79-95. An interview with Archie Dunham, former chairman and CEO of ConocoPhillips, appeared in the October issue of the *Journal of Applied Management and Entrepreneurship*.