DEFINING DIRECTORS' CONFLICT OF INTERESTS IN CODE OF ETHICS

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Abstract

We propose a definition of directors' conflict of interests (CoI) by critically reviewing the academic literature. Then, we present an exploratory study, based on a content analysis of the leading Italian listed companies that sought to empirically assess the directors' CoI definitions provided by corporate codes of ethics. We found that despite the presence of CoI statement within corporate codes of ethics, CoI definition is often absent, when present it is not always clear, and differs widely among firms. The consequence is that CoI recognition could be not easy and remedies to prevent and resolve directors' CoI lose their practical utility.

Keywords: Conflict of Interests, Code of Ethics, Corporate Governance

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1. Introduction

With the recent spate of corporate scandals resulting from the questionable behavior of corporate leaders, there have been calls for various governance mechanisms including corporate codes of ethics to guide directors decision-making (Lückerath-Rovers and De Bos, 2010; Akkermans *et al.*, 2007; Stevens *et al.*, 2004; Lere and Gaumnitz, 2003) and prevent unethical behavior (Stevens, 2008; Adams *et al.*, 2001; Schwartz, 2001) of corporate agents.

Since the diffusion of codes of ethics, they have been extensively studied by the academic community. Scholars generally address the content, output and implementation of codes of ethics (Helin and Sandström, 2007; Stevens, 1994). Regarding content, research concentrates on country- or non-country-specific features; specific industries; specific types of organizations, and different kind of ethical issues (Preuss, 2009; Flanagan and Clarke, 2007; Kinchin, 2007; Singh, 2006; Singh *et al.*, 2005; Sirgy *et al.*, 2005; Asgary and Mitschow, 2002; Gaumnitz and Lere, 2002; Valentine and Barnett, 2002; Farrell and Cobbin, 2000; Preston *et al.*, 1995). With respect to output, there is a lively discussion about the effectiveness and quality of codes of ethics highlighting what effects on behavior they have (Helin, 2011; Sigh, 2011; Winkler, 2011; McKinney *et al.*, 2010; Erwin, 2010; Jensen *et al.*, 2009; Kaptein and Schwartz, 2008 and 2001; Stevens, 2008; Lere and Gaumnitz, 2003; Adams *et al.*, 2001; Somers, 2001). In terms of implementation, studies ask why and to what extent companies and other organizations adopted codes of ethics (Haxhi and Ees, 2010; Valentine and Johnson, 2005; Adam and Rachman-Moore, 2004; Wood and Callaghan, 2003) and disclosed such documents (Bernardi and LaCross, 2009; LaCross and Bernardi, 2006).

From a methodological point of view, most studies rely on surveys or collections of corporate code of ethics from a number of corporations. A second reflection is the exploratory, rather than explanatory, focus in the studies (Helin and Sandström, 2007). However, some research attempt to compare codes of ethics by providing different models for analyzing and classifying corporate codes of ethics (Singh *et al.*, 2005; Gaumnitz and Lere, 2004; Lozano, 2001). Finally, there is a scarcity of prescriptive and normative studies on corporate code of ethics based on theories explaining how such codes are implemented in organizations (Helin and Sandström, 2007).

Conflict of interests (CoI) is one of the major themes in corporate codes of ethics and conduct (Snell and Herndon, 2004 and 2000; Gaumnitz and Lere, 2002; Snell *et al.*, 1999). Indeed, corporate codes of ethics frequently mention the term "conflict of interests" (Singh, 2006; Singh *et al.*, 2005). Scholars observe that codes of ethics of professional business organizations in the United States (Gaumnitz and Lere, 2002) as well as public service codes of ethics (Kinchin, 2007) frequently include an obligation to avoid CoI apart from some cases where the CoI is acceptable as long as it is disclosed to all affected parties. In some case, codes of ethics refer to CoI between the company and members of the management board or the supervisory board members (Akkermans *et al.*, 2007). However, none of the studies on corporate code of ethics directly address the issue of directors' CoI albeit it is widely recognized that codes of ethics could help to clarify how directors should behave (Lückerath-Rovers and De Bos, 2010) in order to protect the best interest of the firm (Huse, 2007). As argued by Moore and Loewenstein (2004), CoI are at the heart of many of the recent corporate scandals thereby managing CoI is critical to curbing many forms of unethical behavior in organizations.

This paper contributes to research on boards and codes of ethics in three distinct ways. Firstly, starting from a critical review of the academic literature on CoI, we propose a CoI definition that could be applied to directors in codes of conduct and ethics in order to facilitate its recognition. In this respect, we clarify the differences among actual, apparent and potential CoI of board members as well. Secondly, we empirically assess the definition of directors' CoI by exploring the content of corporate code of ethics in the leading Italian listed companies. Thirdly, we suggest some remedies to manage directors CoI.

The rest of the paper is structured as follows. The framework for analyzing our research question is developed in the next section. In this section we critical review the literature on CoI. The section continues with the argument that CoI is not a clearly defined concept, especially in the case of board members. As a result, we propose a CoI definition that could be applied to directors. In the third section we present our research method. In the fourth section we illustrate our arguments by analyzing the codes of ethics of the leading Italian listed companies. In the fifth section we discuss the empirical results of our analysis. The final section summarizes the conclusions and contributions of the paper.

2. Literature review

2.1 Critical review of conflict of interests' definitions

The term "conflict of interests" is used in many different and often inconsistent ways. One of the major problems with CoI is that there is still a widely held view that CoI is equal to corruption (McMunigal, 1998; Williams-Jones, 2011). But CoI is not a crime. A result of this pejorative or negative connotation is that the term CoI loses much of its utility, in practice. For that reasons there is a need to do a much better job of clarifying the concept, in order to better manage CoI when it cannot be avoided and to make CoI more understandable.

In corporate governance studies normally the concept of CoI is related to that between management and minority shareholders, in firms with dispersed ownership (type I agency problem), or between controlling shareholder and minority shareholders in firms with concentrated ownership (type II agency problem). In agency theory board of directors is one of the mechanisms designed to monitor these CoI (Fama and Jensen, 1983; Jensen and Meckling, 1976; Shleifer and Vishny, 1997). For that reasons boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment in tasks where there is a potential risk of CoI. Some studies emphasize the risk that board's independence could be compromised by the link between the CEO and board members (Hermalin and Weisbach, 2003; Morck, 2008) or between dominant shareholder and board members (Shleifer and Vishny, 1997).

Although a significant amount of research has emphasized the importance of board independence, there is a lack of corporate governance studies investigating the concept of CoI and the different types of CoI (actual, potential and apparent) that could affect both the board members behavior (impairing their independence and leading into corruption) – even the behavior of those directors who are (often only formally) independents (Morck, 2008) – and the outsider observers' trustworthy in respect of board members behavior.

Instead, scholars of other disciplines – in particular philosophers, psychologists and research physicians – have proposed different definitions of CoI, depending on the area in which it was investigated and disciplined (see Table 1). In particular, we can split the CoI definitions in two categories: the definitions that are general (Davis, 1982, 1993; Carson, 1994; Boatright, 1992; Argandoña, 2004) and those that define CoI in specific sectors or for specific individuals (Resnik, 1998, for scientist; OECD, 2004, for public services; Thompson, 2009, for physicians).

Table 1. Conflict of interest definitions

DEFINITIONS	AUTHORS
A person has a conflict of interest if (a) he is in a relationship with another requiring him to exercise judgment in that other's service and (b) he has an interest tending to interfere with the proper exercise of judgment in that relationship.	DAVIS (1982, 1993)
A conflict of interest exists in any situation which an individual (I) has difficulty discharging the official (conventional/fiduciary) duties attaching to a position or office he/she holds because either: (i) there is (or I believes that there is) an actual or potential conflict between her own personal interests and the interests of the party (P) to whom she owes those duties, or (ii) I has a desire to promote (or thwart) the interests of (X) (where X is an entity which has interests) and there is (or I believes that there is) an actual or potential conflict between promoting (or thwarting) X's interests and the interests of P.	CARSON (1994)
I suggest that we modify Davis's definition and apply it to science: A scientist has a conflict of interest if a) he is in a relationship with another scientist or member of the public requiring him to exercise judgment in that other's service and b) he has an interest tending to interfere with 1) the proper exercise of judgment in that relationship or 2) his ability to fulfill his obligations to that person in his role as a scientist […]	RESNIK (1998)
As a preliminary definition, then, a conflict of interest may be described as a conflict that occurs when a personal interest interferes with a person's acting so as to promote the interest of another when the person has an obligation to act in that other person's interest. This is equivalent to asserting that a conflict of interest arises when a personal interest interferes in the performance of an agent's obligation to a principal.	BOATRIGHT (1992)
[…] a conflict between the public duty and private interests of public officials, in which public officials have private-capacity interests which could improperly influence the performance of their official duties and responsibilities.	OECD (2004)
[…] a set of circumstances that are reasonably believed to create a substantial risk that professional judgment of a primary interest will be unduly influenced by a secondary interest. The primary interest refers to the purpose of the professional activity, such as the welfare of patients or the quality of research. The secondary interest is typically financial gain.	THOMPSON (2009)
[…] conflict of interest arises in any situation in which an interest interferes, or has the potential to interfere, with a person, organization or institution's ability to act in accordance with the interest of another party, assuming that the person, organization or institution has a (legal, conventional or fiduciary) obligation to do so.	ARGANDOÑA (2004)

Each of these definitions has some strengths but also weaknesses. The latter occur in particular when these definitions are applied to the board members. This is because some of them do not consider important situations in the category of CoI, while others include situations which we believe are irrelevant for CoI policies.

According to Davis (1982) a person is in CoI in all situations in which, being in a relationship with another, has an interest which tends to interfere in the proper exercise of judgment in that relationship. The relationship mentioned by Davis does not necessarily require that the person works for an organization. One of the most important contributes given by Davis is the classification of CoI in three categories: actual, potential and apparent. We will discuss these categories more ahead.

Davis's definition has been criticized by Lubke (1987) and Boatright (1992). Luebke argued that Davis's conception of interest makes the analysis too broad, while Boatright argued that Davis's emphasis on judgment makes the analysis too narrow, excluding from the category of CoI many improper practices businesses often forbid as CoI.

Starting from Davis's definition, Resnik (1998) gives a CoI definition to apply to science. The proposed definition is however not yet suitable for business organization, because it is too specific, even if it contains some very important elements that we will use in the CoI definition that we propose for the board members. Indeed, Resnik's definition contains a deep analysis of the ways private interests of individuals may interfere with their judgment (see also Davis, 1982) and will.

Also the OECD definition (2004) is referred to a particular CoI that is to the public officials, even if it is easily adaptable to the private sector.

Thompson's definition is even more specific than that of the OECD, because it defines the CoI of particular public officials: the physicians. Particularly useful is the concept of "secondary interest", referred to all financial and non financial interests that could unduly influence a "primary interest".

Carson's definition (1994) is much narrower than that of Davis and is not specific as to Resnik and Thompson's definitions; however, it has the advantage of being more applicable to the field of business. Indeed, Carson says that his definition "implies that a person can be involved in CoI only if he is employed by others (this include those who work for clients) or has "official" duties in virtue of holding position in organization. Those who have no official duties as employees, professionals in private practice, or members of organizations cannot have conflict of interest". Carson's analysis is very useful for understanding the CoI phenomenon, especially because of the many examples he did before arriving to his CoI definition.

Finally, Argandoña's definition (2004) has the advantage of not only recall the individual's CoI but also the organizations and institutional CoI. Moreover the author deeply analyzes the single elements that characterize his definition, making easier the understanding of the situations that fall within the CoI definition.

2.2 Defining directors' conflict of interests

Starting from the definitions mentioned in Table 1, we propose the following definition that could be applied to board members:

The conflict of interests is the situation where a director's secondary interest tends to interfere with the primary interest of the firm.

The CoI definition contains the following three key elements:

- *the primary interest of the firm*;
- the presence of a *secondary interest of the director*;
- and the fact that the secondary interest of the director *tends to interfere* with the primary interest of the firm.

The primary interest is determined by the professional duties that the director has in reaching the (legitimate) interest of the firm. According to Huse (2007), in this article we embrace the firm definition of corporate governance where corporate governance is seen as the interactions between various internal and external actors and the board members in directing a firm for value creation. Thus, this definition of corporate governance is based on behavioral assumptions, where the task of the board of directors is to contribute to "value creation for the firm".

When an individual is hired by a firm as member of the board of directors he or she enters into a fiduciary relationship with the firm. At law, the fiduciary duties of directors require them to place the interest of the firm above their own private or personal interest. In that sense all the directors, and not only the independent ones, must have an independent behavior. Therefore a board member must act to promote the success of the firm for the benefit of its members as a whole. In this respect, the interest of the firm (primary interest) could be summarized with the expression: "value creation for the firm that is sustainable in the long term" (Huse, 2007). Sometimes the primary interest is stated as aims or goals (e.g., promoting the interest of the firm), as obligations (e.g., directors' obligation to promote the interest of the firm) or as rights (e.g., the firms' right to have directors promoting their interests).

Undoubtedly, among the three elements of the CoI, the presence of the directors' secondary (private) interest is what causes more problems. The secondary interest is typically financial gain, but the agent can also have non-financial interests that increase his/her utility at the expenses of the principal's interest (Thompson, 2009). Indeed, secondary interest may also include desire for professional advancement, recognition for personal achievement, and favor to friends and family (Cohen, 2001). In this respect, Thompson (2009) clarifies that the majority of secondary interests are – within limits – entirely legitimate (and desirable) to some extent, but they become critical when they have a greater say in the decisions of the agent as compared with the primary interests.

The third element of the CoI definition requires that the secondary interest of the director "tends to interfere" with the director's duty to exercise his/her professional judgment in accordance with the interest of the firm. Obviously it is not unfair to a certain situation, the fact of getting a private interest, as, for example, when someone changes jobs because of higher remuneration or when he/she helps a friend find a job. In fact, the problem arises when that interest becomes secondary to a primary interest that the individual has a duty to obey as a consequence of the position held and the liabilities assumed.

In addition, according to Resnik (1998) definition of CoI and focusing on director's decision making, we can also say that:

In CoI situations director's secondary interest tends to interfere with: 1) the proper exercise of his/her judgment; 2) the director's ability to fulfill his/her fiduciary obligation.

Following Resnik (1998), our definition emphasizes two components: the impairment of the judgment and the corruption of the will. In the first case director does not properly exercises his/her judgment, while, in the second case, director does not have the ability to fulfill his/her fiduciary obligation. Both of these cases can have adverse impact on directors' objectivity and trustworthiness.

Judgment, according to Davis (1982), is a form of cognitive activity, such as decision-making, observation, or evaluation, that requires more than mechanical rule-following or commonsense. Conflict of interests tends to impair the judgment, and it can lead us to make unsound decisions, observations, and evaluations (Resnik, 1998). Conflict of interests can impair judgment in two ways (Davis, 1982; Resnik, 1998). First, a CoI may bias a judgment (Resnik, 1998). A director who is asked to assess or promote a manager (Adams *et al*. 2008) who is also his best friend is likely to make a biased assessment. People who know this bias can compensate for it. Using Resnik example, we can say that this situation is like when we have a thermometer consistently underestimates air temperature by two degrees centigrade, and then we can correct this bias by making adjustments in the temperature we record. Second, a CoI may render a director's judgment unreliable. A director with biased judgment makes errors that are slanted or skewed in a particular way. This case is like to have a broken thermometer that in one occasion overestimates temperature, on another occasion underestimates it, and so on (Davis, 1982; Resnik, 1998).

Moving to corruption of the will, Resnik (1998) observes that "the will is that part of the person that transforms cognitive states into actions". Many situations of director's CoI involve corruption of the will instead of corruption of judgment. For example, we can say that all the situations where directors are called by the dominant shareholder to protect his/her interest - allowing him to extract of private benefits of control and consequently damaging minorities - are in the category of corruption of the will. This is because, differently from bias of the judgment, in corruption of the will director may know how to carry out his/her obligations to minorities, but fails to do so because he/she ignores these duties in order to satisfy his/her private interest (e.g. the maintenance of the sit).

2.3 Identifying actual, apparent and potential CoI of directors

Now using Davis (1982) and Resnik (1998) approach we give the definitions of actual, potential and apparent directors' CoI.

The actual (or real) conflict of interests is the situation where a director's secondary interest tends to interfere with 1) the proper exercise of his/her judgment 2) director's ability to fulfill his/her fiduciary obligation.

The CoI is regarded as "actual" when it occurs during the decision-making of the director (e.g. during a board meeting). In other words, when the director is required to act independently, without interference, the secondary interest tends to interfere with his or her primary interest.

The apparent (or perceived) CoI is defined as follows.

The apparent (or perceived) conflict of interests is the situation where a director has a secondary interest that appears to outside observer(s) to interfere with 1) the proper exercise of his/her judgment 2) director's ability to fulfill his/her fiduciary obligation.

Indeed, an apparent CoI exists when a reasonably well-informed outside observer(s) could have a reasonable apprehension that the secondary interest interfere with the primary interest of the firm. Outside observer may include for example other board members, shareholders, the press, the public.

All CoI involve perceptions or appearances because they are specified from the perspective of people who do not have sufficient information for assessing the actual motives of a decision maker and the effects of those motives on the decisions themselves (Lo and Field, 2009).

Resnik (1998) argue that "in defining apparent conflicts of interest, we can also observe that different people may arrive at different judgments about whether particular situations tend to undermine a person's will or judgment. Although affected parties may agree that a situation is not a conflict of interest, outside observers may have different opinions. […]. Outside observers and affected parties may arrive at different opinions due to differences in knowledge about the situation or differences in their assessments of its ethical aspects".

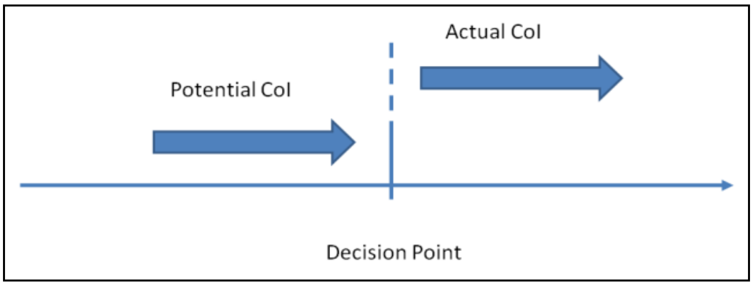
Then, in apparent conflict, the situation is likely to seriously damage the reputation of the director and the organization in which he or she operates, even when the director has no interference in his/her judgment (Thompson, 1993; Winch 2003).

The third type of CoI is the potential one.

The potential conflict of interests is the situation where a director has a secondary interest that could interfere, in the future, with 1) the proper exercise of his/her judgment 2) director's ability to fulfill his/her fiduciary obligation.

In other words, the directors' potential CoI arises when the director has private interests that could turn, in the future, to be conflicting with his/her duties. A potential CoI entails "foresee ability". For example, all the directors who have family and/or professional relationships with the management or the main shareholder are in potential CoI, as well as directors who have financial interest in customers (i.e. director has a partial ownership in a company that buy goods from the firm) or supplier of the firm. These ties could bring an actual CoI in the future (Figure 1).

Figure 1. Potential and actual conflicts of interests



That is why codes of best practice of corporate governance cannot consider those directors as independent directors, even if they are outside (affiliated or "grey") directors (Weisbach, 1988; Vicknair *et al.*, 1993; Denis and Sarin, 1999; Hillman *et al.*, 2000; Klein, 2002).

Apparent and potential CoI can be as damaging as actual or real conflict.

3. Research method

The research method consists of a critical literature research and empirical analysis. Our critical review of CoI literature is based on the largest online collections of published scientific research in the world (EBSCO, ScienceDirect, WileyInterscience, SCOPUS). We extracted the articles that have proposed new interesting insights into the CoI definition in the academic debate, looking at title, abstract and keywords. As a result of a critical reading of all the extracted papers, we selected the most salient contributions to the definition of CoI and reported them in Table 1. As a result, we integrate these contributions by proposing a general definition for the directors' CoI, distinguishing among actual, apparent and potential CoI of board members.

Then, we empirically explore the content of corporate codes of ethics in the leading Italian listed companies to assess their correspondence with the proposed framework on directors' CoI. According to Huff (2008) research protocol, we carried out a close examination of the corporate codes of ethics of these companies looking at the disclosure of directors' CoI in the light of the main characteristics emphasized by the literature.

This explorative analysis is based on the collection of corporate codes of ethics disclosed by the 57 Italian companies listed on the STAR segment of Borsa Italiana (the Milan Stock Exchange, Italy). The choice of this segment is extremely significant because it is dedicated to midsize companies with a capitalization of less than 1 billion euros who voluntarily adhere to and comply with the following strict requirements:

- High transparency and high disclosure requirements;
- High liquidity (minimum 35% of free float);
- Corporate Governance in line with international standards.

In addition, the companies listed on the STAR segment are leaders in their industry and they represent Italy's economic diversity and strong competitiveness as showed by Table 2.

Table 2. Profile of the selected companies

	Frequency
Number of firm listed on the Star segment of Borsa Italiana	76
Number of firm with a code of ethics downloadable	57
Sectors	
- Industrials	27
- Consumer Goods	11
- Heath Care	2
- Consumer Services	7
- Telecommunications	2
- Utilities	3
- Financials	6
- Technology	11

4. Empirical results

The analysis on the data collected was divided into five different areas:

- Scope of the code of ethics;
- Tools for implementing the code of ethics;
- Salience of CoI in the code of ethics;
- Presence of CoI definition in the code of ethics; and
- Content of CoI definition in the code of ethics.

Table 3. Scope of the code of ethics

Addressee of code of ethics	Frequency	%
Shareholders	6	11%
Directors	50	88%
Employee	53	93%
Collaborators	51	89%
Subsidiaries	30	53%
External parties (es. Suppliers)	45	79%
Generic	4	7%

The ethical codes of the sample analyzed are normally addressed to directors, employees and collaborators (see Table 3). The 53% is extended to the subsidiaries of the issuer. It seems interesting to underline that the percentage of codes extending the application to external parties (e.g. suppliers, agents) is 79%. Table 4 focuses on the tools of communication and dissemination of the codes.

Table 4. Tools for implementing the code of ethics

Tools for implementing the code of ethics	Frequency	%
Delivery by hand	19	33%
Online disclosure (on the company web site)	23	40%
Intranet	10	18%
Posted on notice board	8	14%
Declaration of awareness	9	16%
Possibility to ask to the office in charge of the function	6	11%
Training courses	15	26%

The instrument most used for communication and dissemination of the code of ethics is the publication on the company's website (40%). The 33% communicate the code by hand delivery, especially in case of the new intake. Only 26% of the codes contemplate the training courses among the means of communication and dissemination.

Table 5. Salience of CoI in the code of ethics

Number of pages	Average	Min	Max
Pages of the code of ethics	18	6	43
Pages of the code of ethics dedicated to CoI	1	1	2
Lines dedicated to CoI	15	3	43

The number of pages of the ethical code is 18 on average (see Table 5), with a minimum of 6 pages and a maximum of 43 pages. All codes contain a CoI statement. The average number of pages dedicated to CoI statement is only 1. Thus, it has been calculated the average number of lines dedicated to the CoI. At this regard we found that the average number of lines is 15, with a minimum of 3 and a maximum of 43.

Table 6. Presence of CoI definition in the code of ethics

Kind of CoI definition	Frequency	%
Presence of direct CoI definition	10	18%
Presence of a list of CoI situations	5	9%
Presence of indirect CoI definition	22	39%
Presence of direct CoI definition and of a list of CoI situations	3	5%
Presence of indirect CoI definition and of a list of CoI situations	4	7%
Absence of CoI definition	13	23%
Presence of the terms "apparent", "actual", "potential"	29	51%
Description of the difference among the terms "apparent", "actual", "potential" CoI	0	0

From Table 6 we observe that 18% of the ethical codes provide only a direct definition of CoI, where the latter is meant as a clear indication of what the code of ethics intends for CoI. For instance, we consider as direct definition all the cases where we have found "CoI is" or "CoI occur when".

However, if we add the codes providing both direct definition of CoI and a list of CoI situations, the codes providing a direct definition reach an overall score of 23%. We consider the presence of a list of CoI situations in all the codes that specified the various situations that could lead the agent in CoI. Then we consider as “a list of CoI situations” cases like this: “Examples of some of the more common ways where CoI can arise are as follows: Outside jobs or affiliations (…); Interests in other businesses (…); Corporate opportunities (…); Nepotism (…)”.

In addition, we observe that 39% of ethical codes provide an indirect definition of CoI. We consider as “indirect definition” all the cases where in CoI statement is indicated the primary interest (e.g. interest of the firm) that agents must reach and the secondary interests (e.g. financial interest) that could influence, or interfere, or conflict with the primary one.

The percentage of indirect definition reaches a score of 46% if we consider also the codes adding a list of CoI situations. We highlight that 9% of the ethical codes provide just a description of CoI situations, whereas 23% of the codes provide neither definition nor description of CoI even if they indicate the remedies to prevent o resolve CoI. In sum, 77% of the codes provide a direct definition and/or indirect definition of CoI and a description of CoI situations. Finally about half of codes of ethics consider the different kinds of CoI. If we consider only the codes of ethics providing a definition of CoI the codes quoting the term “apparent”, “actual” and “potential”, achieved the 66%, even if no codes specify the difference among these terms. The content of the 39 direct and indirect definitions of CoI has been analyzed and reported in Table 7.

Table 7. Content of CoI definition in the code of ethics

Category	Content	Frequency	%
1. What is CoI (just where a CoI definition is present)	1.1 CoI is a "situation …"	13	33%
	1.2 CoI is an "activity …"	5	13%
	1.3 CoI is a "behavior …"	0	0%
	1.4 CoI is “the case where …"	7	18%
	1.5 CoI is a “situation …” and an “activity”	9	23%
	1.6 CoI is a “situation” and a “behavior”	0	0%
	1.7 CoI is an “activity” and a “behavior”	1	3%
	1.8 CoI is a “situation” and “the case where”	1	3%
	1.9 CoI is a “situation”, an “activity” and “the case where”	1	3%
	1.6 Others	2	5%
2. Types of primary interests	2.1 Duties and responsibilities	1	3%
	2.2 Firm’s interest	20	51%
	2.3 Shareholder interest	0	0%
	2.4 Firm’s interest and duties and responsibilities	16	41%
	2.5 Firm’s interest and shareholder interest	2	5%
3. Types of secondary interests	3.1 Personal Interests (PI)	4	10%
	3.2 Familiar Interests (FI)	0	0%
	3.3 Financial and Economic Interests (FEI)	1	3%
	3.4 Interests Different from Firm Interest (IDFI)	0	0%
	3.5 Others (O)	0	0%
	3.6 PI and FI	7	18%
	3.7 PI and FEI	5	13%
	3.8 PI, FI and FEI	10	25%
	3.9 PI, FI, FEI and IDFI	3	8%
	3.10 PI, FI and IDFI	1	3%
	3.11 PI, FEI and IDFI	3	8%
	3.12 PI, FEI and O	1	3%
	3.13 PI and IDFI	4	10%
	3.14 PI, IDFI and O	1	3%
4. Term used for the third element of CoI definition	4.1 “tends to interfere”	2	5%
	4.2 “interfere”	11	28%
	4.3 “encumber”	7	18%
	4.4 “Influence”	3	8%
	4.5 “conflict”	18	46%
	4.6 “contrast”	3	8%
	4.7 Others	18	46%

The CoI is considered as a "situation" in the 60% of the ethical codes, whereas 37,5% consider the CoI as an "activity". No codes of ethics consider the CoI only as a "behavior", however one code consider the CoI as an "activity" and a "behavior".

Subsequently, we analyzed the definitions provided by the codes of ethics according to the scheme offered by the directors' CoI definition outlined by analyzing the literature. Thus, we looked at the kind of primary interest, the kind of secondary interest and the term used to describe the third element of the theoretical definition of CoI.

As regards the kind of primary interest, the firm' interest is the most quoted (98%) whereas the shareholder interest is the less cited (5%), and only together with the firm' interest. Finally, duties and responsibilities are considered as primary interest in 41% of ethical codes albeit with the firm' interest, that is nearly always quoted.

Among secondary interests, the most relevant interest is the "personal interest" that is quoted by 98% of ethical codes, whereas the "financial and economic interest" and the "familiar interest" are respectively included in the CoI definition in 58% and 57% of ethical codes. In 30% of cases, ethical codes also cite interests different from the firm' interest.

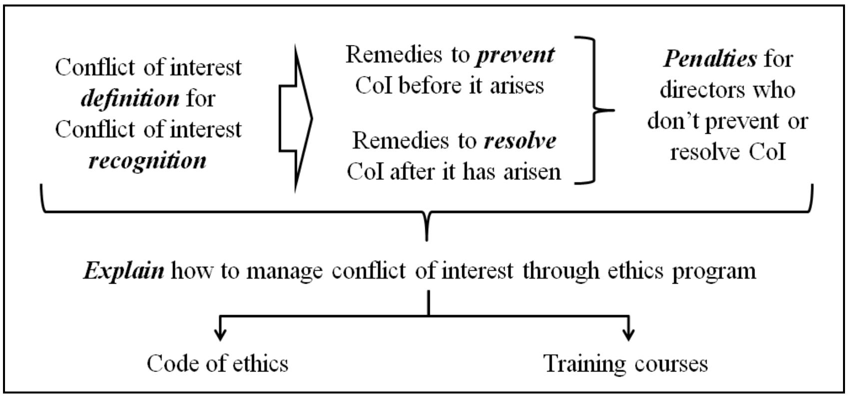
The third element of CoI definition is obviously that presenting a wide variability. The most quoted term is "conflict" (46%), followed by "interfere" (28%) and "encumber" (18%). Finally, we underline that 46% of ethical codes use others terms for describing the relation among primary and secondary interests.

5. Discussion and conclusion

The results indicate that CoI definition is often absent in codes of ethics and when present it is not always clear. In addition, CoI definition differs widely among firms. Indeed, the term CoI is frequently used in many different and often inconsistent ways, especially if we consider the difference between actual, potential and apparent CoI. This distinction is extremely important to manage CoI effectively, because CoI remedies could be differentiated according to the three types of CoI. But the codes of ethics of our sample never specified these differences. As a result, the remedies to manage directors' CoI lose much of their practical utility.

However, the first step to deal with CoI is to clearly define what CoI is, in order to recognize it when it happens and consequently to activate the remedies to manage it (see Figure 2).

Figure 2. Managing conflict of interest



The remedies we suggest only concern the "risk rules" and not also the "harm rules". McMunigal (1998) clarifies that "a harm rule is about sin, a risk rule about temptation". In other words the remedies to manage CoI are not built just for fraud prevention but to manage the risk that directors could be in situations that lead into fraud.

Under the risk rules, we distinguish the policies to prevent CoI before it arises from the policies that are aimed at resolving CoI after it has arisen (Figure 2). The latter policies are not necessarily alternative but complementary to the preventive measures.

Because CoI is not a crime, as the corporate frauds, some of the punitive crime prevention methods (Murphy and Dacin, 2011; Sutherland et al., 1992) are not applicable for this phenomenon. For example we cannot punish with the jail a CEO that is just in a CoI situation (e.g. he owns a partial ownership in a firm that is one of the firm's customer), but the firm could provide punishment if the CEO doesn't disclose his or her financial interest that could be interfere with his or her duties and responsibilities (e.g. removal of the board member from the firm).

Avoid CoI situations is undoubtedly one of the first and more effective policy to prevent CoI, and consequently the situations that could be a source of crime (Argandoña, 2004; Chugh *et al.*, 2005; Moore and Loewenstein, 2004; Thagard, 2007; Thompson, 2009). Directors must avoid placing themselves in a position that may lead to an actual, potential or apparent CoI. This policy is necessary when the severity of CoI (Thompson, 2009) is particularly high (e.g. because of the value of the secondary interest).

The aim of the avoidance of apparent CoI is clearly to protect the reputation of the firm and to permit it to operate effectively and with integrity (Carson, 1994). Moreover, a director cannot be perceived by the outside observers as being impartial and acting with integrity if he or she could derive a personal benefit from a decision.

Certainly avoid CoI is the most effective way to manage CoI especially because it allow to eliminate simultaneously actual, potential and apparent CoI. But this remedy is not always practicable. In some cases it is better to find other solutions aimed at resolving conflicts after they have arisen (e.g. when is in the firm's interest to allow a transaction where a directors have a private interest). Disclosure is definitely the most recommended solution, often provided by law, to resolve CoI and it is not necessarily alternative but complementary to the preventive measures (Argandoña, 2004; Carson, 1994; Thompson, 2009). Indeed, CoI disclosure is also important to activate the prevent policies.

A director must disclose any private interest to the other members of the board, so not just the actual but also the apparent CoI. It allows the board deciding what is the best way to resolve the conflicts, without the interested director's participation. Directors' CoI may be authorized at board level when doing business with the director is in the firm's best interests. In this case, the board must assess the opportunity to request to the director: to stay away from the seat before the discussion; to not exclude the director from discussion, but from the vote.

Policies should also provide penalties for directors who don't prevent or resolve CoI, even in the absence of harm to the company (Figure 2).

Penalties for breach of the CoI prevention and resolution policies may include, but should be not limited to, the following: (1) excluding the board member from portions of all future meetings and discussions which relate to the stated CoI, and/or; (2) censure of the board member, in private, in public, or both, and/or; (3) removal of the board member from the firm.

Legislations often provide penalties, but just in case of harm to the firm. Indeed, some laws provide penalties if failure to disclose gives rise to loss or damage to the firm or third parties (e.g. creditors). For example art. 2629-bis of the Italian Civil Code state that "Any director or member of the board of management of a company with securities listed on regulated markets in Italy or other European Union Member States or distributed among the public to a significant degree […] is punished with a term of imprisonment of between one and three years, if the violation gives rise to loss or damage to the company or third parties".

Then, while the law punishes the failure to disclose just in case of damage, codes of ethics can provide penalties even in case of no damage. The aim is not to just prevent the risk of fraud but to manage the risk that directors could be in a CoI situation.

After establishing remedies to manage CoI and penalties for the breach, it is necessary to transfer these policies to the board members behavior through ethics programs (Figure 2). Ethics programs normally include code of ethics and ethics training (Valentine and Fleischman, 2008).

To facilitate guidance to employees, managers and directors most companies incorporate a CoI statement within their corporate codes of ethics (Preuss, 2009). Certainly, no code or policy can anticipate every situation that may arise. Codes of ethics, especially for board members, do not attempt to describe all the possible CoI. That is why codes of ethics should provide a clear CoI definition and the explanation of the differences between the harm and the risk of CoI as well as the differences among actual, potential and apparent CoI. These definitions could be considered as a general guideline to directors in order to allow them to recognize the various forms through which the conflict occurs and to respect the rules provided to manage it.

Because the CoI recognition is not always easy, even if code of ethics contain a clear definition of what actual, potential and apparent CoI are, firms should also provide CoI training program for board members and for the key management (e.g. lectures and videos), making examples to facilitate CoI recognition and management (Handfield and Baumer, 2006; Stevens *et al.*, 2005).

Valentine and Fleischman (2004) observe that ethics training "should ideally teach individuals the ethical requirements of the organization, as well as how to recognize and react to common ethical problems experienced in the workplace". Moreover, Palmer and Zakhem (2001) wrote: "merely having standards is not enough, a company must make the standards understood, and ensure their proper dissemination within the organizational structure". Thagard (2007), who studied the moral psychology of CoI and in particular the way minds make ethical judgments, say that "people also need to be educated concerning the prevalence of motivated inference, so that they can watch for cases where their conclusions derive more from their personal goals than from the available evidence, keeping in mind that even the friendship of a lobbyist can have distorting effects on their judgments".

We can conclude by saying that CoI definition and recognition are at the base of the policies to manage CoI. Consequently practitioner should pay more attention on the CoI definition and on the effectiveness of ethics programs in allowing directors to easily recognize their CoI. Without CoI recognition it is extremely difficult to activate the procedure provided to manage CoI situations that could be considered as important antecedents of fraud. As a result, the remedies to prevent and resolve directors' CoI lose much of their practical utility.

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