THE BOARD'S ROLE IN ESTABLISHING THE RIGHT CORPORATE CULTURE

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SNAPSHOT

- Good corporate governance is primarily dependent on board members defining a clear moral purpose and modelling core values, sound judgement and leadership behaviours.
- Having a good corporate governance structure and effective processes and systems are also important, but these exist to measure core leadership qualities.
- The mitigation of risk begins with a clear and deep understanding of human behaviour in the workplace. Robots are designed to comply with clear instructions; human beings need inspiration.

MANAGING RISK – IT'S ABOUT PEOPLE AS WELL AS PROCEDURES

"Leadership is a potent combination of strategy and character. But if you must be without one, be without the strategy."

General Norman Schwarzkopf

To understand how to manage risk, look at how people manage risk in extreme environments. Managing risk in war is a great example. Strategy, planning, training, rehearsal and operational excellence are vital. But without character, just cause, judgement, courage, and love for country and comrade, they will lose and they may die.

In business, unless the board displays the same understanding of how to lead 'hearts and minds', then no matter how diligent its governance structure, processes and systems, its plan will not survive contact with the reality of human character, judgement and behaviour.

The overwhelming evidence of history is that human communities only function and sustain themselves when people:

- Have a clear moral purpose;
- Truly care for each other;
- Co-operate and make good decisions about how to get the scarce resources they need in a hostile environment;
- Do all these things in a way that sustains their environment for future generations.

Governments and business leaders who build a cage of laws, regulations and internal processes become high risk, dysfunctional, mindless, fear-driven, bureaucratic, totalitarian communities, dominated and exploited by narrow elites. Just as we are seeing the decline of totalitarianism in the nation-state, for example in Egypt, Libya and Syria, we are also seeing the end of the corporation as a feudal construct. Yes, organisations need effective governance to help mitigate risk. But without moral purpose, character, judgement and behaviour, they will not prosper or survive.

THE MORAL PURPOSE OF BUSINESS

Why does a business exist? Perhaps it is to make money. But unless it is clearly understood how it makes money, it will not make money for long.

The reality is that the purpose of business is to offer human beings a social environment to co-operate and to share know-how and resources in order to meet their needs. A business only exists when it functions as a community that brings together investors, entrepreneurs, employees, customers, suppliers and communities to provide goods and services to each other. Whilst making money is an important measure of success for investors, entrepreneurs and employees, a business will not make money for long unless its customers get quality goods and services at a price that is fair. It will also fail to make money for long unless it treats the members of these various stakeholder groups with empathy, fairness and respect. This is the moral component of purpose in business.

Some good examples of well-run businesses with a clear moral purpose are Nationwide Building Society, The Co-operative Group and The John Lewis Partnership. These businesses have not only survived in the current economic downturn, they have positively thrived. It is no accident that each of these businesses is a mutual or partnership. Mutuality is the form of association that underpins families, friendships and the best local communities. It has been proven over thousands of years. Corporatism, on the other hand, is good for short-term success, but bad for risk and for sustainability.

CHARACTER, JUDGEMENT AND BEHAVIOUR

The banking crisis of 2007-9 prompted several inquiries into the apparent failures of governance that precipitated it. They included the Walker Review into the corporate governance of banks, which for the first time addressed the question of the 'character' of bank directors and senior managers.

The Financial Reporting Council (FRC) also reviewed its UK Corporate Governance Code. I co-authored a submission to the FRC's review with David Phillips, Senior Corporate Reporting at PWC, which sought to address the same issues of the character, judgement and behaviour of directors and boards. The submission stated:

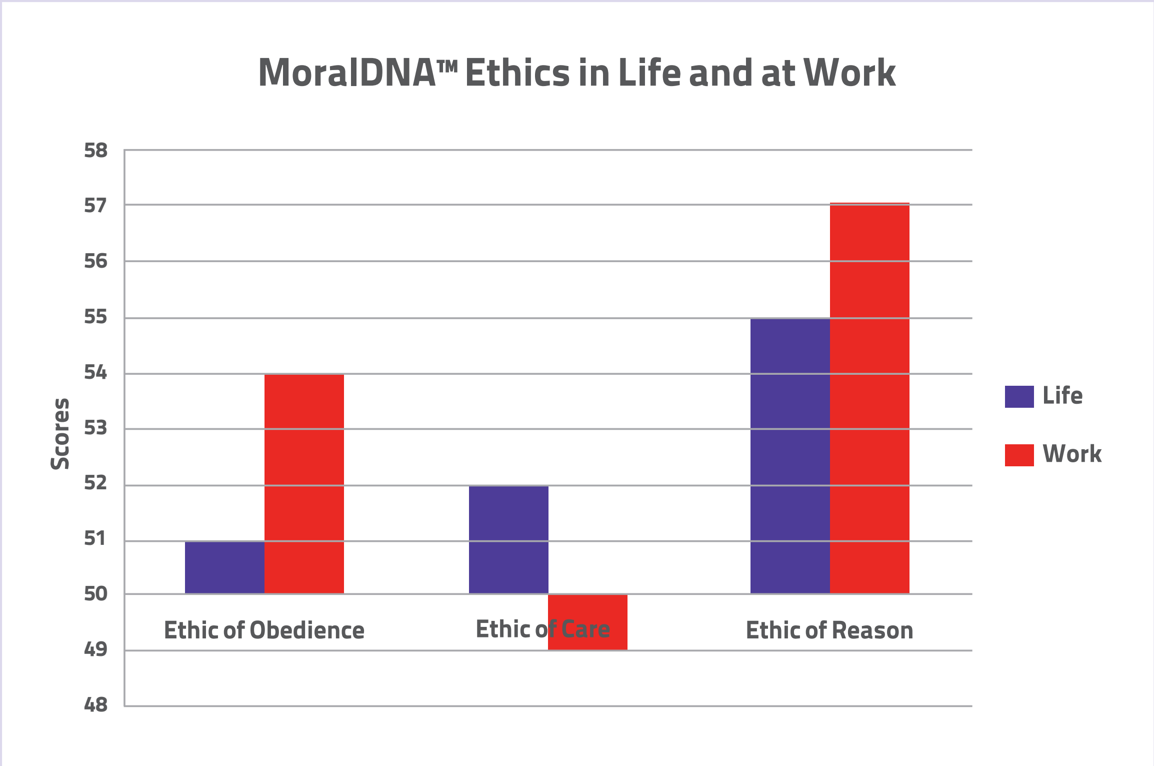
"Character, judgement and behaviour are connected stages in a process. Character or integrity is the sum total of all our moral values and informs the behaviour of trusted adults. Good collective judgements and decisions are made when we consider not only legal rules and obligations (which should be regarded as the 'letter' of the law), but also how our values (the 'spirit' of the law) help us to decide fair and reasonable outcomes for all stakeholders. We must also acknowledge that this process will vary according to the situational context faced by boards. As a consequence, it is critically important not only that the behaviours of organisations are better understood, but that there are processes in place to monitor the environments in which they operate, particularly to identify those situations when rational human behaviour is most challenged."

The fundamental failure of governance that precipitated the banking crisis was not because directors failed to understand financial risk; it was because they failed to govern with courage and integrity. This failure was not caused by a lack of technical knowledge; it was caused by failures of character, judgement and basic arithmetic. As we continue to pick over the wreckage of our financial system, it is clear that many post-mortems into corporate governance are fixated by board structures, remuneration policies and risk management systems. They do not focus in any meaningful way on the behaviour of human beings, *per se*.

It is baffling that boards, government and regulators seem to ignore the powerful tools now available to measure and change human character, judgement and behaviour. Even bus drivers are routinely given personality tests to measure whether or not they can exercise self-control in stressful driving conditions. So why not also test directors and senior managers to understand their character and decision-making skills?

Results from a well-established integrity test, the 'MoralDNA' profile*, clearly demonstrate how and why failures in character and judgement lead to high-risk behaviours. The bar chart opposite measures the ethics in life and at work for over 1,000 directors and senior business executives, in corporations with a combined market capital in excess of £200bn, who have taken the test. It shows how their preference for making decisions based on the ethic of obedience increases when they go to work. On the face of it, this might be considered a good thing. However, the research also shows that their ethic of care is suppressed at work. The combined effect of both of these phenomena is actually to increase behavioural risk. If people become more compliant, they also become more robotic. They are less likely to think, to question or to challenge any instruction. This, of course, is fine if the instruction is ethical, but what if it is a newspaper editor demanding a phone-hacked scoop or a sales director demanding a sales target that forces mis-selling? If, at the same time, businesspeople are also suppressing their ethic of care, then *de facto*, they will not feel guilty about hacking someone's phone; the victim is just a story, rather than a human being. Likewise, they will be willing to mis-sell a bond to a 90 year-old, who is seen not as a person, but as a sales target.

But all is not lost. For these directors and business leaders, their default 'life' scores as human beings are all above the global average score of 50. This finding, together with experience of working with the boards and senior leaders of major corporations, provides the most powerful solution to the challenge of governance, moral leadership and culture. The evidence confirms that the vast majority of directors are good people who 'do the right thing'. However, when people come to work, they suppress some of their judgement and some of their humanity. They become thoughtless and careless. The simple but challenging solution is to create the right environment, the right culture, for directors, for leaders and for all employees to bring their humanity to work.



"CULTURE EATS STRATEGY FOR BREAKFAST"

This is a quote from a very senior executive responsible for safety at one of the major oil and gas players. The point he was making is that managing risk in high-risk businesses such as his ultimately boils down to the character, judgement and behaviour not just of individuals, but of social groups in the workplace. This is what we call 'culture'. Every workplace has a culture. But it is self-evident that many boards and senior executive teams do not properly understand the culture of their business and then, by definition, fail to influence it in a way that not only mitigates risk but also enhances the value of the business.

Returning to the aforementioned submission to the FRC, the following were the recommendations on leadership and culture:

"Character and behaviour

Furthermore, we believe the system can be further strengthened if work is undertaken to increase boards' understanding and awareness of the character and behavioural mix that is more likely to support an effective governance environment. In particular we suggest that the FRC should:

- *Conduct research and encourage market experimentation around the use of tools and techniques that can be used to assess the character and behavioural profile of directors and boards; and*

- *Consider ways in which boards and individual directors can develop a conscious, diligent and verifiable collective decision-making process, that captures the essence of what is meant by the FRC in its references to 'character' and 'behaviour' throughout its July 2009 consultation document.*

External reporting – exposing culture, values and behaviours

In a similar vein to the point made above, it may also be beneficial for boards to explain the behavioural tone which is established in the way it engages with shareholders and the management team and in the actions it takes. This can be seen as a statement of 'who we are' and 'what we stand for'. In this context, boards may wish to explain what management style and behavioural norms they encourage and what behaviours they will not tolerate. Here an understanding of the actions and penalties that have been put in place to deal with such exceptions could provide added impact."

THE MORAL MAZE

The challenge for boards is to decide whether corporate governance can be effective without moral leadership and culture. If the answer is 'no', then board members need to understand their personal and collective character, judgement and behaviour. This requires insight, oversight and expertise not found in rulebooks, tick-boxes and codes of conduct, but in moral philosophy and social psychology. In short, they need to understand who they are, how they decide what is right, what they do and their role as leaders in meeting these challenges.

KEY ACTIONS FOR BOARD MEMBERS

- Question the purpose of your business. Is it meeting the needs of all your key stakeholders?
- Challenge your own values, decision-making and behaviours as leaders. Are you bringing your humanity to work?
- Ask colleagues, customers, suppliers and local communities how they really feel about your business. Does it inspire them? Do they love it? Why and in what way?
- When you have the answers to these questions ask yourself: "What are we doing well that we need to keep doing?", "What are we beginning to do well, but need to do more of?" and "What are we not yet doing and need to begin?"

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* *The MoralDNA profile is a short personality test that sets out to reveal a person's moral values and the way they prefer to make decisions about what is right. Developed in 2008 by Professor Steare and chartered psychologist, Pavlos Stamboulides, the profile now measures 13 factors to describe character and judgement and has so far been completed by more than 50,000 people from over 200 countries, many of them business leaders. The results from this research are now being referenced by the FSA and the SFO, given their respective mandates on mitigating financial market and corruption risks. To take the profile, visit www.MoralDNA.com*

THE IMPORTANCE OF BUSINESS CULTURE, ETHOS AND BEHAVIOUR

Mr Arthur E. Andersen, founder of **Arthur Andersen**, is said to have cemented his reputation when he told a local railroad chief that there was not enough money in Chicago to persuade him to agree to enhance reported profits by using 'creative' accounting. He lost the account – but the railroad firm went bankrupt soon after. Mr Andersen had a clear moral compass.

By the 1980s, the firm was adopting the 'Big Five' auditors' new business model: grow the business by selling consultancy on the back of the audit relationship. Andersen did well. It embraced a '2x' model – bring in twice as much consultancy as audit revenue. Those who succeeded in doing this were rewarded, whereas those who did not perform faced sanctions. Fear of losing consultancy work must have pervaded audit teams.

Through its work for **Enron**, Andersen earned $25m in audit fees and $27m in consultancy fees in 2000. Over the years, Andersen had been involved in creating and signing off creative accounting techniques, such as aggressive revenue recognition and mark-to-market accounting, along with the creation of special purpose vehicles (SPVs) used for doubtful purposes. By 2001, the firm was sufficiently concerned for 14 partners, eight from the local office that handled Enron, to discuss whether they retained sufficient independence from Enron. Having observed that revenues could reach $100m, they decided nonetheless to keep Enron's account. Mr Andersen might not have reached the same conclusion.

As news of the US Securities and Exchange Commission's (SEC) investigation into Enron spread to Andersen, the Houston practice manager gave the audit team a lecture. When it had recently been investigated by the SEC, Andersen had learned that most of the SEC's ammunition came from Andersen's own files. He therefore pronounced that, while they could not destroy documents once a lawsuit had been filed, "if [documents are] destroyed in the course of the normal [destruction] policy and the next day a suit is filed, that's great." A few days later, Andersen's in-house lawyer, having seen some embarrassing internal memos, sent an email to the Houston office stating: "It might be useful to consider reminding the engagement team of our documentation and retention policy." In the next few days, Andersen's shredders in Houston, London and elsewhere were working overtime. This loss of moral compass was an important cause of the firm's collapse.

Business culture, ethos and behaviour matter. Mechanically applied rules, guidance and a 'compliance culture' are not enough.

Source: Roads to Ruin