Private Sector Opinion

# Integrity, Culture, and Other Intangibles for Building Long-Term Value—The Board's Critical Responsibility

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John H. Stout

In many companies affected by scandal, directors do not understand or pay close attention to their core duties: care, loyalty, good faith, compliance, and oversight. Directors must use the tools at their disposal to effectively execute their responsibilities.

## Foreword

John H. Stout presents us with a fundamental and urgent call to duty to boards of directors: Integrity is the solid answer to providing society with a safe, sustainable, and balanced business environment; and boards have a crucial role to play in assuring an organization's integrity. That said, the task is an ambitious one, considering the current status of our business environment.

In the last 17 years since I have been involved with corporate governance, I have witnessed cycles of crisis succeeded by stricter regulation and more complex self-regulation around the world. These new rules are presented as remedies and insurance to protect the international economy and to assure sound capital markets. If we search for similarities in these different cycles, such as the corporate scandals of the beginning of the century or the financial crises that emerged in 2008, we may find a common element embedded in them: a crisis of confidence and trust that resulted from lack of integrity.

If the regulatory framework is constantly being improved, why does this happen? Notwithstanding the robustness of the rules and the enforcement mechanisms in crisis after crisis, why aren't markets safe? The answer is that an attitude of mere compliance is not enough,

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The Global Corporate Governance Forum supports corporate governance reforms in emerging markets and developing countries. The Forum develops advanced knowledge and training products promoting good practices in corporate governance and facilitates capacity building of director training organizations engaged in implementing corporate governance reforms.

The Forum partners widely with international, regional and local institutions, and draws on the guidance of its global network of private sector advisors and academic research network.

The Forum is part of the IFC Corporate Governance Group, located in the Environment, Social and Governance Department. It is a donor-supported facility, co-founded in 1999 by the World Bank and the Organisation for Economic Co-operation and Development (OECD).

although even that attitude is not necessarily prevalent in the business arena. We must go back to the basic values and principles that drive human behavior.

Stout invites us to pay attention to the core elements, the basic grounds where the safeguards against failures of trust are rooted: a culture of integrity that provides the basis of stakeholder and public confidence in an organization. Stout clearly states that boards are ultimately responsible for the company's integrity, and directors should see the organization's integrity as an extension of their own integrity. When boards succeed in doing so, an environment of trust is created; and that trust turns into value by reducing uncertainty and concerns about organizational misconduct.

This paper presents a practical guide for boards on how to fulfill their responsibilities of being the guardians of integrity and their company's culture by discussing common causes of board failures. Stressing that relationships based on integrity add value to organizations, contribute to their sustainability, and promote their reputation, Stout points out the board's responsibility in creating and maintaining such an organizational culture. Several key topics are explored: the commitment of the directors, the ideal board composition, the fiduciary duties of directors, the selection of the CEO, the role of directors in the creation of internal controls, the remuneration of directors and officers, and risk management. Furthermore, Stout defines the role of the board with respect to relationships with stakeholders—an issue that in many companies ends up being the focus only of management's attention.

If you are a board director, you will benefit from the road map that Stout provides to being a steward of the money and assets of others. Should boards learn the clear lessons presented in the following pages and make use of the tools described, their companies' value, reputation, and sustainability will be ensured; and markets will be a safer place for the benefit of all stakeholders.

***Sandra Guerra***

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# Integrity, Culture, and Other Intangibles for Building Long-Term Value—The Board's Critical Responsibility

John H. Stout[1]

## Integrity: The Board's Primary Responsibility

Governance is a discipline different from management. Understanding that concept is the first step toward improving board practices. While management designs, recommends to the board, and executes the company's strategy and business plan within an agreed budget, governance focuses on active, vigorous oversight of the company and its management. The challenge for board members, typically those who have excelled at management, is to develop excellence in *governance*.

Fundamental to good governance is recognizing that an organization's integrity is critical to its value, reputation, and sustainability. Organizational integrity starts at the top with the board and senior management—hence, the frequent reference to the "tone at the top" as a key element of corporate governance.

Integrity is the basis of stakeholder and public confidence in a company. While stakeholders look to boards and senior management for overall governance, direction, and control of a company, the key stakeholder expectation concerns the organization's integrity and, specifically, assurance that the corporation's values and culture support that integrity.

In practice, this means that the board—

- Oversees without compromise the selection, evaluation, and retention of directors of high integrity and skill;
- Selects its leadership and both organizes and populates its committees to facilitate the board's effective performance;

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- Remains uncompromising in the selection, evaluation, and retention of executive management of high integrity and skill; and,
- Recognizes with senior management (in supporting the board's efforts) their joint roles in ensuring that the organization has and practices values that support a culture of integrity, fairness, trust, and high performance.

Trust is fundamental to leadership. Boards and senior executives must be sensitive to the signals they send to stakeholders and employees. Signals to stakeholders include the quality, independence, reputation, skills, and values of director nominees; the board's governance standards; and responsiveness by the board and senior management to key stakeholders' concerns regarding management compensation, related-party transactions (e.g. family members, suppliers, customers, consultants, and others with business or family ties), and other matters. Signals to employees include selection of board members; hiring and promotion of personnel; behaviors that are endorsed or permitted at the board, management and staff levels; employee remuneration and other rewards; and the treatment of employees, suppliers, customers, shareholders, and other stakeholders.

*In many corporate scandals, boards failed because they did not take responsibility for their organization's integrity. The directors did not see the organization's integrity as an extension of their own integrity. Ultimately, that is the critical point.*

The board (the "governing authority" in the language of the Revised U.S. Federal Sentencing Guidelines) is ultimately responsible for the company's integrity (and culture as discussed later). In many corporate scandals, boards failed because they did not take responsibility for their organization's integrity. The directors did not see the organization's integrity as an extension of their own integrity. Ultimately, that is the critical point.

Above all, the board and senior management must see that the conduct of the company's business reinforces, rather than detracts from, its integrity and that it enhances, rather than reduces, the value of the company's goodwill. Accordingly, disclosures and comments made by senior management and the board must have integrity and must accurately reflect the true state of the company's affairs. The company's values, in turn, will often be reflected in its intangible assets or "goodwill". For most companies—particularly such high-profile companies as Starbucks, Apple,

Microsoft, Petrobras, Berkshire Hathaway, Infosys, and Tata—the goodwill on their balance sheets may, and often does, outweigh the monetary value of their tangible assets. It's critical that the board and all employees—especially management, advisors, and consultants (particularly, its lawyers and accountants)—act to protect and enhance the organization's integrity and goodwill.

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## Goodwill

Goodwill is a type of intangible business asset, the difference between the fair market value of a company's individual assets and the market value of the overall company as a going concern. A buyer of a company may be willing to pay more for the company than its book value because the company's profitability, reputation, brand, unique market position, customer loyalty, and special skills may help generate above-average earnings.

## Board Accountability

In the last decade, there have been many examples of failures in corporate integrity: Enron, Worldcom, Tyco, AIG, Lehmann Brothers, Barclays, Citigroup, Credit Suisse, Bank Santander, News Corporation, Olympus, Sino Forest, Reliance Group, and Satyam Computer Services are some examples. One study estimates that 7 percent of firms commit fraud every year, with the median cost of a fraud estimated at 40.7 percent of the company's pre-fraud enterprise value.[2]

Shareholder concerns about the company's integrity, the board's role in building and preserving a culture of integrity, and overall perceptions of the company will be strongly influenced by the board's ability to govern according to best practices. Decisions must be made in a transparent manner so that shareholders and others can hold directors accountable. While the possibilities for slippages or failures in board practices are wide, some common causes for board failures are discussed below.

[2] Alexander Dyck, Adair Morse, and Luigi Zingales, "How Pervasive is Corporate Fraud?" May 2007. http://www.business.illinois.edu/accountancy/events/symposium/audit/2010/papers/Dyck.pdf .

## Composition of the Board and Top Management

Board composition is the number one issue in today's governance environment. The board's ability to perform its fiduciary responsibilities effectively depends on the competence, knowledge, experience, objectivity and values of its members. Boards have the responsibility to select capable directors, known to be ethical (and screened for past legal and ethical issues), knowledgeable about governance, oversight, and industry in which the company operates, and capable (having the time, energy, knowledge, judgment, leadership, and courage) to effectively discharge their responsibilities.

*The challenge in emerging markets is that families that control the company tend to occupy board and managerial positions, and succession planning is often focused on family members, regardless of their qualifications, and not on professional managers where needed.*

Also critical to board composition is the independence from management of at least a majority of the directors selected. While the specific criteria determining whether a director can be considered to be independent vary worldwide, all share a broad definition that independent directors are free of any material involvement in the company—through direct or family-related employment, providing services as a vendor, or being related to other directors or employees. (See box on page 8 for more information.) The challenge in emerging markets is that families that control the company tend to occupy board and managerial positions, and succession planning is often focused on family members, regardless of their qualifications, and not on professional managers where needed. Similarly, companies may be part of or controlled by a business group, the interests of which may not coincide with those of the company. Further, the pool of independent, qualified candidates can be small in many emerging markets.

Public and private boards tend to be dominated by individuals who have management backgrounds, but, as noted earlier, governance is different from management. Success as a manager does not always translate into effectiveness as a director. Boards, particularly those that have presided over companies with severe problems, have often been accused of being too management-centric. Directors with successful management backgrounds are needed for Boards, but so are other voices and perspectives.

Today's boards should be comprised of people with the varied views and skills needed by a particular company. Some of the commonly required skills and expertise include governance and board leadership, business analysis (what activities add to, or detract from, the value of an enterprise or industry), risk assessment and management, industry knowledge, legal and regulatory expertise, international business experience for companies doing business internationally, human resources (including understanding of corporate culture dynamics, strengths, and weaknesses), accounting, audit, finance, marketing and sales, communications, stakeholder relations; and, expertise in rapid growth or rapid decline scenarios. As a board looks for the appropriate level of diversity to maximize the variety of perspectives for its deliberations, it should equally look for gender, age, and ethnic diversity. As the company evolves, so too should board composition.

Alongside its responsibilities of CEO oversight, the board must also oversee the CEO's selection of key management individuals who have responsibility for the corporation's strategy, business performance, finances, reporting, human resources, risk assessment, and legal compliance. These personnel include the CFO, controller, internal auditor, risk manager, investor relations officer, internal counsel, and head of information technology. Periodic one-on-one interviews with these individuals are an essential tool for directors and board committees as they perform their oversight responsibilities.

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## Independent Directors

Definitions vary as to what *independent* means, but usually they describe a person who is free of financial, family and employment ties or any other meaningful relation with the company, its directors, and employees. To summarize:[3]

The director

- is not a recent employee;
- has no recent material business relationship with the company;
- has received no recent or current compensation from the company, other than director's fee, share options, or performance-related pay or pension;
- has no close family ties to any of the company's advisors, directors, or senior employees;
- has no cross-directorships or significant links with other directors through involvement in other companies or bodies;
- is not a significant shareholder; and,
- is not a long-term member of the board

Experts differ over the number of independent directors that a board should have. Depending on the country and whether the company is publicly traded, the range advised is from one-third to a substantial majority. As a minimum, there should be enough independent directors to staff the governance, audit, compensation, and (if applicable) risk committees.

George Dallas and Melsa Ararat, in their *Private Sector Opinion*, raise questions about the benefits of board independence in emerging countries. The evidence, they maintain, is inconclusive, suggesting that "nominally independent directors are not independent enough or not really independent at all. The independent directors may also be in such a minority on many boards that they are ineffective in the face of non-independent or affiliated directors."[4]

[3] IFC Global Corporate Governance Forum, "Corporate Governance Board Leadership Training Resources." http://www.gcgf.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/global+corporate+governance+forum/publications/toolkits+and+manuals/leadershiptoolkit .

[4] George Dallas and Melsa Ararat, "Corporate Governance in Emerging Markets: Why It Matters to Investors—and What They Can Do About It." *Global Corporate Governance Forum Private Sector Opinion 22*. 2012. Available at: http://www.ifc.org/ifcext/cgf.nsf/AttachmentsByTitle/PSO_22_Melsa/$FILE/IFC_PSO_22_070611.pdf .

## Fiduciary Responsibility

In many corporate scandals, directors demonstrated their lack of understanding of what it means to be and act like a "fiduciary." Whether serving public, private, family-owned, or government-controlled companies in Asia, Africa, South America, Europe, or North America, directors need to behave as fiduciaries, or stewards of others' money and assets. Directors must always:

- act in good faith;
- place the organization's best interests above all other interests—personal interests, the interests of those who elected or appointed them, lobbyists' concerns, government officials' interests, and owners' motivations (multiple owners may have multiple agendas); and,
- act with care by making well-informed, properly considered, objective decisions that focus on the enterprise's best interests untainted by conflicts.

## Corporate Culture

Corporate culture has been a serious problem in many high-profile corporate failures. Examples of greed, inappropriate executive compensation and perks, placing profit and personal gain (through self-dealing and insider trading, for example) above legal compliance and ethics, and excessive risk-taking are numerous. Board oversight of corporate culture is critical. The Revised U.S. Sentencing Guidelines place on an organization's "governing authority" (i.e. the board) the responsibility for ensuring the existence of an ethical culture that emphasizes compliance with laws. Building and maintaining such a culture requires close cooperation between the board and management.

*Board oversight of corporate culture is critical. Building and maintaining an ethical, legally compliant culture requires close cooperation between the board and management.*

Integrity is further served—or undermined—by the quality of a company's internal controls, compliance procedures and processes, and disclosure practices. The maintenance of a strong corporate culture and the creation of positive impressions of that culture among employees require periodic independent assessments of the company's ethics, values, compliance, and training programs. (These programs should be designed to instill the appropriate corporate values, familiarize employees with the company's ethics and compliance expectations, and ensure that those expectations are met.) Management must establish processes and procedures for preventing and detecting violations of laws, regulations, company policies, governing documents, and codes of ethical conduct. Periodic reviews by the board should assess the efficacy of those processes and procedures to assure they are functioning as expected.

*Management must establish processes and procedures for preventing and detecting violations of laws, regulations, governance documents, and various company policies and codes of ethical conduct with proper oversight over, and periodic assessment of, the efficacy of those processes and procedures.*

Remuneration is one of the most provocative issues illustrating integrity and values. Excessive director and executive compensation, for example, particularly when the company's performance has declined, reflects poorly on directors' independence, integrity, and judgment. Boards must take more oversight responsibility for policies governing compensation, perks, incentives, performance reviews, promotions, retirement, and severance pay. Boards must ensure that management establish an overall compensation philosophy and policy for the organization that is fair, transparent, and responsive in rewarding excellent performance, addressing poor performance and that is designed to attract and retain the best talent without detracting from the corporation's integrity or corroding the company's culture.

Boards must carefully assess and address actual and perceived conflicts of interest. Of particular relevance to some of the emerging markets is the frequency of board insensitivity to conflicts of interest. This is manifested, for example, in the prevalence in some regions of inappropriate related-party transactions[5], a topic that the OECD[6] has been exploring with particular reference to governance in Asia. According to the

[5] Pratip Kar, "Culture and Corporate Governance Principles in India: Reconcilable Clashes?" Private Sector Opinion #23. August 10, 2011. www.gcgf.org/publications

[6] OECD, "Related Party Transactions and Minority Shareholder Rights." April 4, 2012. http://www.oecd.org/corporate/corporateaffairs/corporategovernanceprinciples/relatedpartytransactionsandminorityshareholderrights.htm

Corporate Executive Board Company, compared to the global average, local employees observed 700 percent more improper payments in China, 250 percent more conflicts of interest in Brazil, 250 percent more fraud in India, and 350 percent more business information violations in Russia.[7]

## Understanding Risk and Oversight

Key among a board's responsibilities is understanding, identifying, and addressing risk. In analyzing and approving strategy, many boards fail to sufficiently assess organization, business, strategic, financial, technology, legal, and personnel risks and to balance those risks against opportunities for improving performance and growth.

Lack of understanding of risk on the part of boards was highlighted during the recent financial crisis. "A lack of effective risk governance is found at the top of the list of governance failures" for financial institutions, write Laura Ard and Alexander Berg in summarizing several studies.[8] Specifically, Ard and Berg identified three failings:

- Many boards did not possess a comprehensive understanding of their institutions' risk profile and were not able to judge its appropriateness.
- Senior management failed to adopt and integrate the necessary systems to identify, manage, and report risk.
- Risk management units did not have the visibility, stature, or independence to raise and consolidate risk to a level sufficient to prompt management and board response.

Boards must strive to understand risks, pay attention to warnings, and confront problems promptly and forthrightly. Policies and procedures for assessing and monitoring risks are essential, and directors must ensure that such policies and procedures are put in place and function well. Warnings need to be heeded and promptly reviewed to determine whether further investigation or action is required. This entails thorough efforts to obtain all relevant information, using independent resources where necessary to assure objectivity.

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[7] Ian Beale, "Audits Response to Risks in Emerging Markets." September 18, 2012 post. http://cebviews.com/adr/2012/09/18/audits-response-to-risks-in-emerging-markets-2/ .

[8] Laura Ard and Alexander Berg, "The Financial Crisis: What Are the Corporate Governance Lessons for Emerging Markets" in United Nations Conference on Trade and Development, ed., *Corporate Governance in the Wake of the Financial Crisis.* http://www.unctad-docs.org/files/CG-in-Wake-of-Fin-Crisis-Ch3.pdf

Often directors don't truly understand their oversight roles and fail to appreciate and use the oversight tools at their disposal. Non-management directors, for their part, are sometimes intimidated by management, uncritically reliant on management, or passive when it comes to critiquing or challenging the views of management and the advisors engaged by management. This type of failure, in particular, had serious consequences in the first decade of the 21st century. Enron and Satyam come to mind. Boards soliciting the views of third-party experts or periodically seeking second opinions could help mitigate this problem.

## Risk Management

Risk management is the process of identification, analysis, and either acceptance or mitigation (for example, how to best handle such exposure) of uncertain outcomes of decisions and actions. The Committee of Sponsoring Organizations (COSO) and others have published guidance (as far back as the Treadway Commission Report, sponsored by COSO, in the late 1980s) for board deliberations involving tangible and intangible risks.

"Corporate risk taking and the monitoring of risks have remained front and center in the minds of boards of directors, legislators, and the media, fueled by the powerful mix of continuing worldwide financial instability, ever-increasing regulation, anger and resentment at the alleged power of business, financial executives and boards. Board compensation practices have been a lightning rod during this time of economic uncertainty, retrenchment, contraction, and changing dynamics between U.S., European, and emerging market economies, receiving constant media criticism, shareholder intervention, and regulatory attention."[9]

Some boards establish a separate risk committee, led by an independent director, to monitor the level of leverage, industry sector trends and competitiveness criteria, government policy and other macro-economic factors, and the company's finances (exposure to loans, shift in market demand, production costs, including social benefits for employees), and other various issues as they arise.

[9] http://blogs.law.harvard.edu/corpgov/2012/01/03/risk-management-and-the-board-of-directors-an-update-for-2012/

## Transparency

The board must ensure not only that management has systems and procedures that will sound early warnings of activities that could threaten the company's integrity, but also that the company's financial statements are understandable, transparent, comprehensive, and reliable for those assessing its financial condition and evaluating whether to invest in or do business with the company.

During the U.S. dotcom market crisis of the early 2000s and the recent financial crisis, there were many transparency issues surrounding accounting and disclosure. Worldwide, hundreds of companies' financial results were restated. Even if there was technical compliance with accounting principles, financial statements and published information often failed to provide a true picture of companies' business and financial condition. To address this issue, the Sarbanes-Oxley Act required certification by the CEOs and CFOs of the accuracy of company financial statements, and compensation clawbacks in the event of certain restatements of audited financial statements. The membership of some emerging markets countries in the "G20" has led them to adopt some reforms; but, given that "countries in Asia, the Middle East, Africa, and Latin America were generally less impacted financially by the crisis, [t]heir financial reform initiatives since 2007, if any, have generally not risen to a level of prominence comparable to those in the United States, the European Union, and Switzerland."[10]

*Boards must be aware of the many ways in which the corporation provides information, including public comments by management, media interviews, press releases, websites, broadcast or directed e-mail, regulatory agency filings, and a multitude of forms, applications, and disclosures to third parties.*

Boards must closely monitor information that is being disseminated by the company. Transparency is good; obscuring reality is bad. Boards must be aware of the many ways in which the corporation provides information, including public comments by management, media interviews, press releases, websites, broadcast or directed e-mail, regulatory agency filings, and a multitude of forms, applications, and disclosures to third parties (for example, reports to banks and others providing financing or credit regarding compliance with financial covenants), and director and management conduct (for example, purchasing or selling the company's stock). Equally important, and

[10] Nicolas Véron, "Financial Reform after the Crisis: An Early Assessment." Breugel Working Paper. 2012/01. http://www.bruegel.org/publications/publication-detail/view/680/ .

with the potential for significant impact on the company and public perceptions, are external information sources such as analyst reports, positions taken by proxy advisors, competitors' public disclosures through such media as advertising, as well as internet commentary on blogs, websites, and chat rooms.

## Stakeholder Engagement

Financial crises, corporate failings, and governance problems have caused shareholders to seek greater engagement with boards and senior management. Through direct contact, the submission of proposals for inclusion in proxy material and say-on-pay votes, shareholders have sought to influence corporate policy and decisions. With some notable exceptions that include Berkshire-Hathaway, Pfizer, Coca-Cola, and Prudential, to name a few, boards and senior management in the United States, for example, have often been unresponsive or resistant to shareholder initiatives. In emerging markets countries, "shareholder/stakeholder relationships" have long been characterized by the prevalence of relationship-based or relationship-governed behaviors. … Businesses protect themselves by building informal networks or relationships with stakeholders that help secure trust, commitment, and loyalty in the absence of an effective regulatory framework."[11] These dynamics in developed and emerging markets countries have helped to increase the pressure on companies from shareholder advocates.

*Boards and senior management have often been unresponsive or resistant to shareholder initiatives. In emerging markets countries, "shareholder/stakeholder relationships" have long been characterized by the prevalence of relationship-based or relationship-governed behaviors.*

Reputations take years to build but moments to lose. Boards must monitor the governance views of business, the company's shareholders, and other stakeholders, institutional investors, proxy advisors, legislators, regulators, and governance commentators. These groups' views must be considered against the company's established governance policies and practices. For most organizations, their reputations, based on a positive stakeholder perception and the resulting goodwill, are among the most valuable assets. Boards must be alert to external opinions and both individual and organizational conduct that may compromise the company's reputation for integrity and trustworthiness.

[11] Loke Min Foo, "Stakeholder Engagement in Emerging Economies: Considering the Strategic Benefits of Stakeholder Management in Cross-Cultural and Geopolitical Context." *Corporate Governance* 7(4),2007): 379–387. www.eabis.org

Boards should participate with management in developing and maintaining key stakeholder engagement policies and utilize best practices for communications, interaction, and responsiveness. Boards must seek to understand stakeholder concerns and views on different corporate matters, including the director nomination process and company performance issues, and demonstrate a willingness to engage with shareowners and their representatives on these matters. Avoidance is no longer workable. Further, boards and management must be very selective and discerning in decisions to oppose corporate reforms and governance practices advocated by responsible stakeholders.

*Reputations take years to build but moments to lose. For most organizations, their reputations, based on a positive stakeholder perception and the resulting goodwill, are among the company's most valuable assets.*

## Conclusion

In conclusion, boards must embrace good governance practices in actuality, not just in appearance. Many companies' boards, however, even those which have had "gold standard" governance documents and processes in place, often lack a solid grasp of these "best practices" and how to implement and monitor them. Good governance is about organization, process, education, and *execution*—and, finally, *effective evaluation* of management, principally the CEO, and the board and individual directors.

## RESOURCES

The Forum has published toolkits and editions of its series *Private Sector Opinion* and *Focus* to provide more information. All are available on the Forum's website: www.gcgf.org/publications. Some of these include:

- **Achieving Effective Boards:** This publication surveys the corporate governance landscape and sets out recommendations from the Latin American Corporate Governance Institutes network about key issues relevant to board effectiveness: Director board duties, handling of conflicts of interest, selection and structure criteria, criteria for independence, and board committees.
- **Diversity at the Head Table: Bringing Complementary Skills and Experiences to the Board.** Yılmaz Argüden discusses why a well-functioning board of directors needs diversity of experience and perspectives.
- **Corporate Governance and Development—An Update:** Stijn Claessens and Burcin Yurtoglu sift through scores of academic studies on various countries, sectors, and business organizations—from state-owned enterprises to publicly listed companies—to determine how corporate governance can influence economic development and well- being, and what is needed to promote good practices.



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