Board Briefing

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Ethics, Risk and Governance

By Peter Montagnon

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Doing business ethically ...
.... makes for better business

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Ethics, Risk and Governance: a board briefing paper

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Contents

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Peter Montagnon joined the IBE as an Associate Director in September 2013. Prior to that he was Senior Investment Adviser at the Financial Reporting Council, which he joined after almost ten years as Director of Investment Affairs of the Association of British Insurers.

For two decades from 1980 Peter was a senior journalist on the Financial Times, including spells as Head of the Lex Column and in charge of coverage of the international capital markets. His last assignment, from 1994 to 2000, was as Asia Editor, responsible for the FT's coverage of a region stretching from Pakistan to New Zealand.

After graduating in Modern Languages from Cambridge University in 1972, he joined Reuters news agency as a financial journalist. At Reuters he completed assignments in Hong Kong, Zurich and Washington before joining the Financial Times.

Peter served on the European Commission's Corporate Governance Forum from 2005 - 2011. He is past Chairman of the Board of the International Corporate Governance Network and is also a visiting Professor in Corporate Governance at the Cass Business School of the City University, London, a member of the Corporate Governance Advisory Board of the Norges Bank Investment Management and of Board of the Hawkamah Institute for Corporate Governance, Dubai.

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Foreword

At the Institute of Business Ethics, we believe that doing business ethically makes for better business.

The board is the forum for reviewing holistically the company's stakeholder relationships. In reality it is the only forum for doing so as it directs the company's purpose, business model and strategy.

The better board does this based on the company's values. Those key words such as honesty, fairness, transparency, which when truly embedded and part of the corporate DNA are the foundation as to *how* the business is done, whatever the sector, whatever the situation.

And better business will be the result as this is how a company builds trust.

A better business is one which enhances the lives of its stakeholders: by being a great place to work; by treating suppliers with respect and paying on time; by marketing responsibly; by reporting transparently; by minimising impacts to the environment; by considering its tax obligations.

A better business is also more sustainable in the long-term: by reducing integrity and reputation risk; attracting top talent; increasing brand loyalty; enhancing shared value. A more trustworthy business is a more secure one.

If a board's core purpose is to ensure the sustainability of the company, then these positive benefits of doing business ethically make it imperative for boards to embrace ethical standards explicitly, both in the way the company and the board itself operates in line with its values.

From the IBE's experience of working with many companies in many sectors internationally, we share the accepted premise that a company's culture is influenced by the tone from the top. This is not only in promoting values but also through example and behaviour, as senior leaders demonstrate what it means to be living the company's values.

However, boards sometimes need a starting point to begin explicit conversations on values. The IBE has prepared this paper to inform these discussions.

We welcome any feedback as we seek to raise awareness and share practice of this important element of the role of the board.

Philippa Foster Back

Philippa Foster Back CBE
Director
Institute of Business Ethics

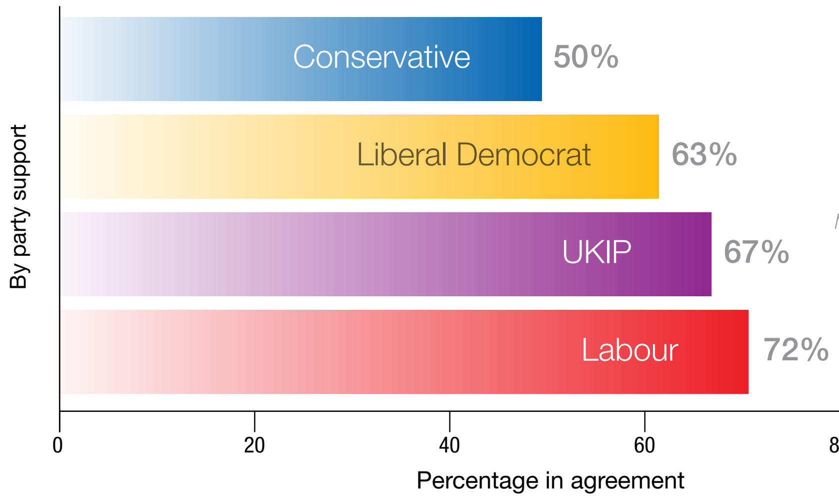
Executive Summary

"We want to be proud of Enron and know that it enjoys a reputation for fairness and honesty and that it is respected." So wrote Chairman Kenneth Lay in the forward to the final edition of the company's Code of Ethics, published in July 2000 less than 18 months before it collapsed. Lay was later found guilty of ten counts of fraud.

Building on the experience of Enron and others, this paper sets out why directors need to be actively involved in setting and maintaining a company's ethical values and building trust. It suggests some ways to approach this. Many boards acknowledge the importance of a healthy corporate culture, both because of the role this plays in mitigating risk and because of the value to their franchise of a sound reputation. A healthy culture also reduces politics inside the company and makes for more engaged employees. While there is often a temptation to see embedding culture as largely a compliance exercise, values actually go to the heart of what a business is and how it works.

There are two reasons why the values approach is important. One is that a series of corporate scandals, not just at banks, has eroded public trust in business. A recent survey for the *Financial Times* showed half of those who would vote Conservative – traditionally seen as the most business-friendly party – wanted the government to crack down on big business.

Figure 1 Voters seeking tougher government action against big business



> Whichever party wins the next general election, the next government needs to be tougher on big business

Source: *Financial Times*, 7th May 2014 'Voters turn against big business culture, claims Populus survey'

Companies need public trust if they are to secure their franchise for the long term. It is no longer enough to justify their existence as being merely to maximise shareholder value in the shortest possible time. The other reason is that no one can run a business without having a business model, and all business models reflect the conscious or unconscious values of those who designed them.

Values are thus a primary task for boards, and an integral part of their governance role. The UK Corporate Governance Code acknowledges this when it says: *"The board should set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met* [1]*."* There are three parts to this task:

Boards have to set appropriate values and ensure they are embedded.

Boards need to understand how to influence behaviour throughout the company so that employees will make good decisions. This is a complex task. It is different and more difficult than the simple setting of values. Yet it is critical. Many companies proclaim their values, but what distinguishes the outstanding ones is the way in which this translates into actual behaviour. A focus on what drives behaviour within the company is a key task for boards.

Boards need to understand where their oversight role begins and ends and what is the operational role of the management. It is therefore important to clarify the contribution that boards can make.

This paper aims to shed light on these three issues and help directors define their contribution to the maintenance of sound values and culture. This is also an issue which could usefully be picked up in the board evaluation process.

> *Boards need to understand how to influence behaviour throughout the company so that employees will make good decisions*

The business model is core. A sound business model aims to generate returns by delivering value to customers in the form of products which they want and which are reliable and affordable. Essentially it puts the customer first. But not all models operate in this way. Some are flawed at the outset, and some become contaminated because executives become preoccupied with exploiting opportunities to extract value for themselves. This is perhaps epitomised by the behaviour of US mortgage bankers in the run up to the financial crisis when they were falsifying their clients' income statements in order to earn bonuses for themselves by selling mortgages their customers could not afford. Having sound values is more likely to lead to a robust and sustainable business model.

Incentives and targets play a large part in determining behaviour, but so does a corporate values system that discourages cheating and encourages fairness, transparency and respect. Boards need both to understand how the business model delivers value and whether it is operating in the way it is supposed to. It is not always easy to see when standards slip or when a product like payment protection insurance (PPI), which at the outset appeared to have a useful social purpose, has suddenly become toxic.

[1] Financial Reporting Council (2012) *UK Corporate Governance Code*, Supporting Principle A.1. www.frc.org.uk

A flawed or poorly operating model is not sustainable. It invites rebellion by customers and retaliation by regulators. Worse, it signals to employees that it is all right to behave badly. Companies that are particularly vulnerable are those whose business involves complex products, complex pricing and/or weak competition. An example is the British energy utility sector which was criticised for its opaque pricing policy and for not returning cash balances promptly to customers who switched suppliers. That left a regulated industry friendless at a politically sensitive time. The experience shows that boards need to be continuously aware of the way values operate in their company and of the public perception of the outcome.

None of this is to negate the central importance of profit, which is a legitimate reward for bearing risk and delivering value to customers. Nor is it intended to imply weak moral fibre on the part of directors. Most do take seriously the standards they set for themselves as individuals and want their companies to do likewise. Yet companies are collectives. They have a life of their own and sound values do not come naturally. Without a conscious effort by corporate leaders to define and embed them, there can be a sense of drift.

The required effort goes beyond mere compliance with the law. For many companies with operations in the US, the concern with ethics is driven by a legal motivation to ensure their operation remains within the bounds set by *US Federal Sentencing Guidelines*. These set rules which, if followed, will reduce the sanctions imposed on companies if an offence is proven. The guidelines have in part determined the US approach to compliance. They have led to the appointment of ethics and compliance officers and departments and shaped their role. In the UK, companies have now similarly to contend with the requirements of the Bribery Act 2010.

This paper argues, however, that the issues facing companies are more subtle and go beyond mere compliance with guidelines or specific legislation. The pressures which arise through the way people interact in work groups affect them differently from those which face them in their personal lives. Boards need to feel comfortable that employees will make the right decision under pressure, when they must make choices in situations not specifically covered by the law, regulation or formal company rules. Empty mission statements and formulaic codes of practice will not work. Values need to be genuine and embedded throughout the company. They should cover both business objectives such as service, excellence and innovation and ethical purpose such as integrity, respect and openness. What matters is not only what the company does but how it does it.

“ *Empty mission statements and formulaic codes of practice will not work. Values need to be genuine and embedded throughout the company*

Much of the work of embedding culture is the task of management. Boards, however, have a critical role. They must work with the chief executive and the management team to define the desired culture and hold management to account for delivering what has been agreed. Directors can steer this process, by defining the culture they want, setting an example at the top and monitoring to see whether the message is getting through. The character of the chief executive is crucial because of their operational reach across the company. Boards should take this into account in succession planning, and, if they find themselves saddled with a chief executive who does not reflect the desired values, they may have no alternative but to remove them.

A critical need is to find a way of checking to see whether the workforce's perception of culture and the way staff interpret corporate values actually reflects that which the management believes to be the case. Important indicators include customer complaints, staff turnover, the content of staff surveys, exit interviews and data from whistleblowing or speak up lines.

As mentioned above, boards also need to be alert to the way incentives operate throughout the company. They may think that they have been clear about the importance of health and safety, but sometimes the subliminal signals are strong. If employees are under pressure on deadlines and costs, then health and safety considerations are likely to recede as teams on the ground concentrate on the task in hand. The PPI scandal has been expensive for British banks. It would have been less so if sales teams had been under less pressure to meet unrealistic targets, themselves often designed to deliver bonuses to senior executives. While one task for boards is to ensure that companies meet financial and operational targets, another is therefore to ensure that those targets are clear and reasonable in the first place. Those which are too stretching or involve reward that is too enticing may well lead to trouble.

Finally values are not just about ensuring good behaviour by employees. They are also an important support in decision-making. Boards frequently have to make difficult decisions and address problems to which there is no absolutely right answer. A clearly articulated and consistently applied set of values will at least help find answers that command respect and that stand the test of time. Similarly, directors need also to have a clear policy on managing conflicts of interest, which covers, among other things, the company's approach to financial reporting and, where relevant, its dealings with related parties.

All of this requires time and effort by boards. Some directors will object that they are already weighed down by compliance burdens that squeeze out strategic discussion. Yet values are integral to the definition and development of the business model. They are not a distraction. They are central to the company's success.

Introduction: The Business Case

> *If people trust one another because they are all operating to a common set of ethical norms, doing business costs less.*
>
> Francis Fukuyama (1996) Trust: The Social Virtues and the Creation of Prosperity

One of the important lessons of the 2008 banking crisis has been that ethics matters to business, both in terms of its reputation and its sustainability. A number of factors – from loose monetary policy to weak banking supervision and a failure of corporate governance – were at the origin of the crisis. Yet a failure of ethics, encapsulated in the sale of mortgages to people who manifestly could not afford them, played a defining role.

The banking crisis gave rise to debate not only about regulation, but also about the short term, self-interested behaviour of those involved with financial markets and corporations. Previously, it was received wisdom that companies existed simply to provide returns for their shareholders, preferably over the shortest possible timescale. Now, the role of the corporation and its place in society is under scrutiny amid a general anxiety that business no longer enjoys public trust. This goes wider than banks. GlaxoSmithKline, one of the world's largest and most prestigious pharmaceutical companies, was fined $3bn in the US in 2012 for inappropriate marketing practices and has subsequently faced bribery allegations in China and Iraq. Rolls Royce is facing a Serious Fraud Office enquiry into bribery. The phone-hacking scandal has dealt a blow to the franchise of the Murdoch media empire, and two other companies G4S and Serco have been accused of charging the UK government for tagging prisoners who were already in jail.

Business therefore needs to restore and maintain trust. Indeed, some argue that this is a matter of acquiring competitive advantage [2]. This paper explores the role of directors in building trust. It is informed by the belief that attention to ethical values and culture makes companies more secure and therefore able to generate stable long term returns. Experience shows that failure to address values engenders risk and is associated with corporate lapses, crisis and, even, failure. The role of values is already reflected in the views of both regulators and mainstream institutional shareholders. According to the Financial Reporting Council, *"an effective board should demonstrate ethical leadership, displaying – and promoting throughout the company – behaviours consistent with the culture and values it has defined for the organisation."*

The Organisation for Economic Cooperation and Development (OECD) says the board has a key role in setting ethical values, while from the shareholder perspective, the International Corporate Governance Network says *"companies should engender a corporate culture which ensures that employees understand their responsibility for appropriate behaviour [3]."*

[2] Colin Mayer, professor at the Saïd Business School in Oxford, puts it this way in his 2013 book *Firm Commitment:*

"The moral corporation is an economically efficient corporation. Since most aspects of relationships cannot be specified contractually, they rely on trust. Trust depends on commitments between the parties concerned. Where there is commitment and trust, then values which reflect the interests of stakeholders and the community at large can be credibly sustained. There is therefore a coincidence between positive determinants of economic efficiency and normative ones of social welfare, and the competitive advantage of nations depends on the moral fibre of its corporations."

[3] See Appendix 1.
Also see speech by Martin Wheatley, Chief Executive, Financial Conduct Authority, to CFA European Investment Conference, November 2013: *"... good conduct – integrity if you like – is a global agenda."*
http://www.fca.org.uk/news/firms/competing-on-integrity

Companies cannot operate in isolation from the society from which they derive their franchise. Profit is a legitimate reward to companies, not only for bearing risk, but also for the value inherent in the goods and services they deliver. When profit involves abuse, exploitation or excess, for example as a result of a monopoly position, the chances increase that the public will object. As the banks have found, this can have a profound impact on their licence to operate, and in extreme cases, their very survival.

> *Paying lip service to corporate responsibility will not suffice in the end. Nor will unthinking compliance with a rule book*

A sustainable franchise, however, cannot be bought by seeing the iteration of values as purely tactical expediency or routine compliance. Writing about the failure of the Co-operative Bank, which extolled its own moral approach to lending, Professor John Kay describes as superficial the slogan that (morally) good business is profitable business. Citing Richard Whately, Archbishop of Dublin, he notes that *"when you deal with the man for whom honesty is the best policy, you never know when it might be the occasion on which honesty is no longer the best policy....The integrity we value is a personal or organisational characteristic, not a business strategy* [4]*."*

The challenge for business, therefore, is how to develop and embed real values, not just formulaic ones that are assumed for the sake of expediency. Paying lip service to corporate responsibility will not suffice in the end. Nor will unthinking compliance with a rule book. A positive values system needs to be integral to the company's very being, so that when employees make choices about behaviour, they can be relied on to act in a way that engenders trust. Getting to this point requires leadership and is a core task for boards.

[4] *Financial Times*, November 6, 2013, Being ethical in business is not as simple as 'doing the right thing'. http://www.ft.com/cms/s/0/6ff46438-42eb-11e3-8350-00144feabdc0.html#axzz34QMI3nVo

The Place of Ethics in Strategy and Governance

2.1 The business model is central but values come first

At the heart of every company's activity is its business model. All business models will reflect the company's real values whether or not it has chosen to articulate them, and whether or not its actual values are those which it has articulated. This chapter suggests that the right approach is not to 'reverse engineer' the creation of a values system by working backwards from the business model, but to decide on the chosen values framework first and use that to inform the creation or further development of the business model.

The business model is defined not as the company's vision, objective or ambition - for example to be the largest exporter of English Brie to France by 2025 - but rather as the particular way in which it seeks to generate value. Running an airport is basically a utility business. All companies which do so have to provide safe arrangements for planes to land and take off and for the handling of passengers and cargo. All generate landing fees in return. What distinguishes one airport owner from another is the way in which they generate value out of this activity. That might come from developing the retail space inside the airport, or from an ability to build terminals cheaply and efficiently which will allow the company to expand to new sites. Thus a company's business model takes it beyond its basic activity and defines what sets it apart. This unique proposition is what gives it character and enables it to compete.

> *Values drive everyday behaviour, helping to define what is normal and acceptable, explaining how things ought to be (for example, staff ought to put customers first)*
>
> The Salz Review of Barclays' Business Practice

All companies have business models, though some are not very good at articulating them. Moreover, whether boards are explicit or not, their choice of business model betrays much about the core values of the company. A sustainable business model is one which delivers value to customers by providing them with a reliable product or service at prices they can afford. However, some business models focus more on exploiting customers, for example, those which aim to establish and exploit a monopoly position. Those which exploit are not sustainable because they will eventually provoke a reaction, either through regulatory intervention or because the court of public opinion questions the company's right to a franchise. In the wake of the financial crisis, banks have paid a bitter price as regulators and legislators have now moved to constrain their freedoms to operate and the way in which they run their businesses.

Of course, most board directors are people of principle and it is hard to imagine them endorsing or openly admitting to a business model that involves exploitation of their customers. When this happens it can be because boards have paid insufficient attention to the business model and its impact on customers.

They may believe it to be benign, but in fact all or part of it has become exploitative. The risk is greater in sectors with weak competition, complex products and/or complex pricing structures where employees may easily feel tempted to take short cuts in order to produce good headline results. Quite often also, an activity that appears benign can turn into something exploitative, but the point of transformation is hard to detect. There is nothing wrong in principle in the idea of a bank insuring its customers against being unable to repay their debts, but payment protection insurance (PPI) turned toxic and boards failed to detect the point at which that happened. An important task for boards is to continually consider the customer experience. It may be less positive than they believe.

One, is it legal, two is it profitable, and three is it right?

Moreover, boards which allow customer exploitation to creep into their business models are also implicitly encouraging employees to behave badly. Boards need to ask themselves honestly where their business stands and how their business impacts on society. One FTSE Chair is blunt. *"You have to ask yourself three questions about the business model," he says. "One, is it legal, two is it profitable, and three is it right?"*

2.2 Building trust

If a sustainable business model is one based on values which engender trust, then it is also important for boards to understand trust and the role it plays in their company. Trust is critical to the successful business function because a business is at one level little more than a network of relationships with interlocking accountabilities. Customers must rely on their suppliers. Management must rely on employees. Shareholders must rely on boards. The key point about trust in all these relationships is that it acknowledges a level of vulnerability. Two common definitions of trust are thus [5]:

> *A judgement of confident reliance on a person, group, organisation or system where there is an element of risk, and uncertainty.*
>
> Robert Hurley

> *A psychological state that comprises the intention to accept vulnerability based upon positive expectations of the intentions or behaviour of another.*
>
> Rousseau et al

Boards and companies cannot force people to trust them. The objective must be to make themselves trustworthy in ways that will both help limit risk and make it easier to deal with crisis should it occur. There are three essential requirements:

1. **Openness and transparency.** Especially given the development of social media, people nowadays will not trust an organisation that is shrouded in secrecy.

[5] Hurley R (2006) 'The decision to trust' *Harvard Business Review,* September pp 55-62;
Rousseau DM, Sitkin SB, Burt RS and Camerer C (1998) 'Not so different after all. A cross-discipline view of trust' *Academy of Management Review* 23 (3) pp 393-404.
Both cited in Dietz G and Gillespie N (2011) *Building and Restoring Organisational Trust*, IBE.

2. **A track record for delivering on its promises.** People will not trust a company that delivers late, whose products are unreliable, of poor quality or which end up costing more than expected.

3. **A reputation for honesty and integrity.** People will not trust a company which lies and treats its stakeholders with disdain.

Some boards will argue that their obligation begins and stops with compliance with the law, but mechanical compliance with the law, regulation or even an internal code of behaviour is not sufficient to engender trust. First, there will always be instances which are not covered by the rules and where employees will need to exercise their discretion. Secondly there will always be a risk that some people will seek to circumvent the rules. Boards need to ensure that the company's values are properly embedded. When you can trust employees to make the correct decisions under pressure, you can empower them more, and that creates a virtuous circle in terms of motivation and commitment. The process starts with values, from which ethics are derived, leading to a culture that reflects the chosen values.

The role of directors goes beyond merely assuring that the company is compliant with the various sets of rules to which it is subjected. They need to ensure that the chosen values are properly embedded throughout the company. Such assurance is not just a one-off thing. One of the biggest dangers comes from assuming that trust is still there, when in fact it has eroded. The next chapter looks at the role of boards in embedding ethical values, and creating a corporate culture that will reduce risk and build value over the longer term.

“

Culture exists regardless. If left to its own devices, it shapes itself, with the inherent risk that behaviours will not be those desired. Employees will work out for themselves, what is valued by leaders to whom they report

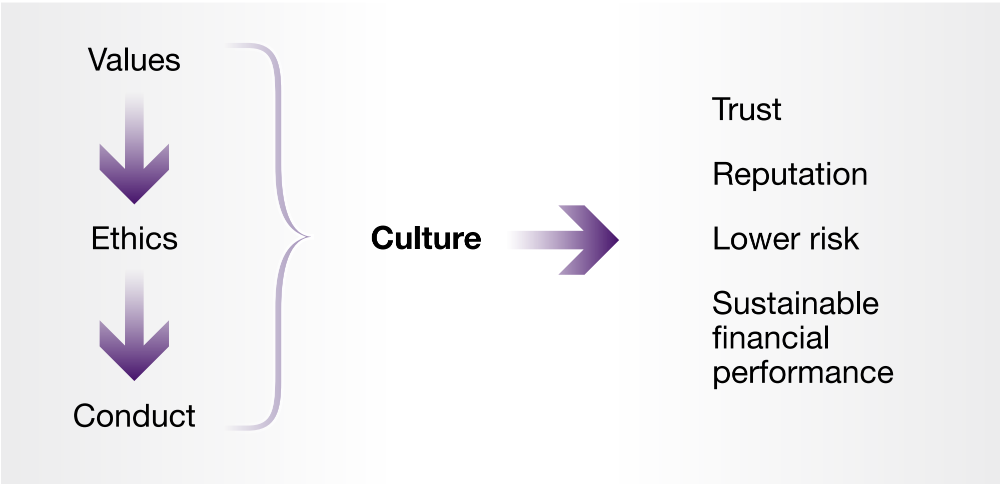
The Salz Review of Barclays' Business Practice

Practical Implications for the Board

So what in practical terms should directors be doing?

We have seen that their role is central in setting values and in ensuring they are embedded so that all employees are encouraged to behave in a way that reflects the company's chosen values. Figure 2 shows the sequence and points to the benefits that arise from a strong business culture, including, importantly diminution of risk and sustainable financial returns.

Figure 2 How culture improves business prospects



Too often companies tend to focus on the *volume* of their earnings. They also need to consider the *quality* of those earnings. Those whose returns are less volatile, because risk, including reputation risk is being well managed will find their shares trade on a higher price/earnings ratio, which means their cost of capital will be lower.

Too often companies tend to focus on the volume of their earnings. They also need to consider the quality of those earnings

There are two parts to the task. One is setting the values themselves. The other is understanding what drives employee behaviour and using that understanding to ensure the values are properly embedded. At the same time boards have to be clear what is their responsibility and what is the task of the management. Their role is crucial but it is not executive, and the task for directors will vary along the way. There are four main imperatives:

1. **Define.** Boards must take an active role in defining the company's values. This will require them to engage in discussions with the management and others about what values the company should espouse and the articulation of best practices which will help ensure these values are embedded in the workforce.

2. **Embed.** Boards must ensure that the values they have agreed are embedded within the company. They have an active role to play here, through setting the right tone from the top and oversight, even if the day-to-day work is done by others. This is not just a one-off task. Sustaining agreed values which could otherwise easily erode requires continuing effort.

3. **Execute.** Most of the execution is the responsibility of the management, just as the board is responsible for risk oversight, while the management is responsible for day-to-day risk management. The board must hire managers able and willing to live the agreed values and nurture a healthy culture.

4. **Monitor.** The board remains responsible for actively monitoring how the values are embedded within the organisation. Four questions that directors can ask to help with this are set out in Box 1.

Box 1 Four questions that directors should ask

1. Does the chief executive exhibit the values expected by the board and are they incentivised to do so?

2. Do employees throughout the business know what is expected of them? Does the board understand what drives behaviour within the company and does it have means of monitoring the gap between expectation and practice?

3. Are financial and operational targets set for employees realistic while still being stretching?

4. Would the board be aware if standards slipped? Is it kept informed of key indicators such as whistleblowing, customer complaints and staff turnover?

3.1 Tone from the top

The roles of the chairman and chief executive are vital in establishing and embedding a system of values. In its guidance for boards the Financial Reporting Council specifically assigns to the chairman the responsibility for ensuring that the company has an appropriate set of values [6]. However, the challenge for both the chairman and the board as a whole lies in ensuring that values set by the board in conjunction with the chief executive are actually embedded throughout the employee base. The example set by individual directors is crucial, but the chief executive can make or break this process because of the way their operational influence extends throughout the company.

Boards should also watch the senior recruitment process. The company may profess strong views about its values, but this will not be credible if it appoints senior managers who do not espouse them.

[6] See Financial Reporting Council (2011) *Guidance on Board Effectiveness.* www.frc.org.uk

A primary task, however, is to hire chief executives who will reflect the values boards desire. A number of directors interviewed for this paper went further. They argued that chief executives who do not represent the desired values, should be removed. It is very difficult to change the behaviour of someone whose values are not compatible. Where this turns out to be the case, removal may therefore be the only option. Boards also need to watch how their chief executive develops in the job. Sometimes the values displayed at the outset can change in ways that may also require corrective action.

Of course, the requirement is not normally as drastic as this. So far we have discussed the importance of values and how they should be integral to succession planning and the way in which the board runs the company. The next chapter looks more closely at what this means in practice.

Instilling and Monitoring the Desired Behaviour

4.1 Incentives are critical

An age-old quandary that continues to bedevil companies is the question of why good people do bad things that end up destroying value, and often jobs as well. Ethical lapses can sometimes be traced back to a 'bad apple' but not always. An unhealthy culture and poorly designed incentives can also be a cause. Indeed, a survey by the American Management Association showed that pressure to meet unrealistic business objectives or deadlines was by a wide margin the strongest factor likely to compromise an organisation's ethical standards. It was ranked in the top three factors by 69.7% of managers, while the next one down – desire to further one's career – was chosen by only 38.5% [7].

> pressure to meet unrealistic business objectives or deadlines was by a wide margin the strongest factor likely to compromise an organisation's ethical standards

Financial incentives play an important role. Remuneration should be related to performance, but, as the banking crisis showed, the expectations built into bonus schemes can have perverse consequences. Target-setting, as the public sector has also found, especially in the areas of education and health, affects behaviour in ways that may not be in the interest of the ultimate user of the public service or of the corporate customer.

Incentives need to be stretching so that employees are pushed to give of their best, but they should not put them in an impossible position because they cannot be delivered without cutting corners. For example, management may wish to give a clear signal that cost control is a priority, but there is a risk of this back-firing if they do not also insist that health and safety considerations must come first. Another area where unfair pressure can be put on people is deadlines. If management expects a task to be done within a tight deadline, then the entire focus of the team can be to deliver. That may involve cutting corners with a damaging impact on quality or, again, on health and safety. Boards are not there to micro-manage, but they do have a role in ensuring that the expectations they place on senior managers – and the expectations the latter in their turn place on more junior employees – are reasonable and deliverable.

UK corporate governance and best practice set out in the UK Corporate Governance Code assigns responsibility for directors' remuneration to boards. It is therefore up to boards to design schemes that work, ideally because they provide a clear line of sight between the remuneration an executive receives and the delivery of relevant performance targets in line with an agreed business model and the appropriate ethics. Unfortunately, that line of sight is frequently lacking. Share incentive schemes, in particular, are seen by many directors as a lottery, offering rewards for meeting arbitrary conditions over which they have no real control.

[7] American Management Association (2006) *The Ethical Enterprise – A Global Study of Business Ethics* (a survey of 1,121 global managers and HR experts).

If I had been paid 50% more, I would not have done it better. If I had been paid 50% less, then I would not have done it worse

The UK Corporate Governance Code also makes clear that companies should not overpay. Competitive pressures encourage boards to pay up for talent. The cost of doing so is often seen as small in comparison with the risk to value of losing a key executive and the cost and uncertainty of hiring a replacement. Shareholders usually take a similar view. This is one reason why executive remuneration seems to be on an inexorable upward trajectory with the result that some executives are paid too much. Jeroen van der Veer, the former Chief Executive of Shell admitted as much when he said on retirement that he would have done the job for much less money, but this is a curious statement after the company's Remuneration Committee had for some years been pushing for more generous terms for its top managers [8]. One of the dangers of overpaying is that executives start to inhabit an unreal world in which they are divorced from the day-to-day reality confronting the rest of the workforce. When this leads to lack of trust and demoralisation within the company the results can be damaging. Equally, if the top management is perceived by employees as helping itself, this gives them an incentive to do likewise, following their example.

There is nothing wrong with high pay for high performance, but the connection needs to be clear and the reward needs to be demonstrably fair. Perhaps most important of all, boards need to beware of incentives which spawn perverse pressures through the company. The notorious case of payment protection insurance (PPI) in the UK is a good example of this. When the bonuses of top executives depended on maximum exploitation of this product, they put pressure down the hierarchy to deliver for them. At more junior levels, according to the Financial Conduct Authority (FCA), sales staff at Lloyds Banking Group were put under pressure to hit targets in order to get a bonus or avoid being demoted. As a result, in one instance an adviser sold protection products to himself, his wife and a colleague. *"Financial incentive schemes are an important indicator of what management values and a key influence on the culture of the organisation,"* the FCA commented [9]. The broader consequence of this type of behaviour for the banking sector has been a multi-billion pound bill in fines and restitution.

4.2 Monitoring behaviour

The effort boards devote to instilling appropriate behaviour is worthwhile because this is a key to protecting value. A study by Keldeep Associates lists a number of levers available to the board and which ones are most frequently used [10].

[8] See *The Guardian,* June 9 2009 'Bonus scam admitted at last'. Mr van der Veer told a conference in Abu Dhabi that *"If I had been paid 50% more, I would not have done it better. If I had been paid 50% less, then I would not have done it worse."*

[9] FCA press release, December 11 2013. 'FCA fines Lloyds Banking Group a total of £28,038,800 for serious sales incentives failings'.

[10] Muir I (2013) *The Tone from The Top,* Keldeep Associates. See also Appendix 2 for more detail.

They include: risk assessments aimed at identifying situations where bad ethical choices could be most damaging (for example false reports to a regulator); the establishment of sub-committees that signal a commitment to business ethics; carefully targeted employee surveys; reliable speak up arrangements; reporting procedures for ethical breaches; codes of conduct, supplemented by training; inclusion of ethics in performance appraisals; external audits; incentive arrangements; and scrutiny of business relationships, particularly where the business partner may have different values.

Several of these are examined in greater detail below. Four general points are worth making in advance, however.

1. The board plays an important role through the way it signals its expectations. It is not just a question of monitoring compliance. Having the chairman regularly communicate the company's values, their purpose and implications – and tying decisions to those values – shows employees that the board is paying attention and means what it says. An ethics and compliance manager with direct access to the board can play a critical role [11]. Similarly, the existence of a board committee focused on values can be an indication to employees that their company takes values seriously and an example of top people seeking to live up to what they are trying to promote.

2. Directors' understanding of the extent to which the desired values are embedded is enhanced if they get out and about in the company so that they can develop their own understanding of how it operates rather than relying simply on information fed to them by senior executives around the board table.

3. Organisational structures matter. Without well-defined organisational structures, accountability is diluted, employees can pursue their own agendas, even to the extent of getting away with unacceptable behaviour. One of the weaknesses of the banks was that merger and specialisation meant that many departments operated in silos, which were out of reach of the general culture and hard for boards to monitor, particularly where teams were "bought in".

4. The risk of reputational damage and damage to the franchise extends beyond the company to key suppliers and joint venture partners. For example, clothing or technology retailers can lose business if their customers discover that their products are purchased from manufacturers with dubious labour practices. Without careful oversight joint ventures can involve some loss of control and dilution of the company's values.

The Keldeep study also points to some danger signs. It says directors should watch out for lack of transparency or lack of information around critical decisions, failure by the executive or non-executives to confront difficult situations, adversarial interpersonal relationships and over-reliance on process rather than dialogue:

> *Executives need to feel that the board is interested and knowledgeable and is likely to find out what is going on one way or the other. This requires strong processes of governance and reporting, and board members who take the time to walk the business, meet the managers and have an open dialogue between executives and non-executives.*

[11] For more detail see Coffey F *The Role and Effectiveness of Ethics and Compliance Practitioners,* IBE, forthcoming 2014.

4.3 Mind the gap

Boards cannot take for granted that agreement on a set of values, or even the existence of a corporate code of conduct actually means that the right culture is embedded. The gap between what the theory says and what is actually going on in practice is very hard to measure. Some useful quantitative information can be derived from indicators such as: the response to staff surveys; staff turnover; the record of customer complaints; the incidence of and trends in speaking up or whistleblowing, including follow-up on how those who raise concerns have been treated; the number of staff dismissed for breaches of the company's code of conduct; and exit interviews.

All of these will give boards some impression of how the company as a whole is doing and point to areas which need strengthening. The most important ones are explored further below. Significant help can come from looking systematically at the difference between what the management says is happening and what employees perceive on the ground. Monitoring of the mainstream press and social media, as well as comments by politicians and other opinion formers, is an increasingly important tool. It can tell directors when the public has detected flaws and, if caught early enough, may create an opportunity to correct the problem before crisis hits. Carefully structured employee surveys can also yield important information.

A critical question for boards is whether employees feel their line manager is living up to the company's code of ethics. Together with the Chartered Institute for Securities and Investment, the IBE has developed a product, Investing in Integrity, which gives companies a detailed comparative view, through an independently run survey, of what management and employees believe is happening [12]. A large gap between theory and practice is a danger sign. Where that is present, directors have a responsibility to address it.

> “get out and kick the tyres

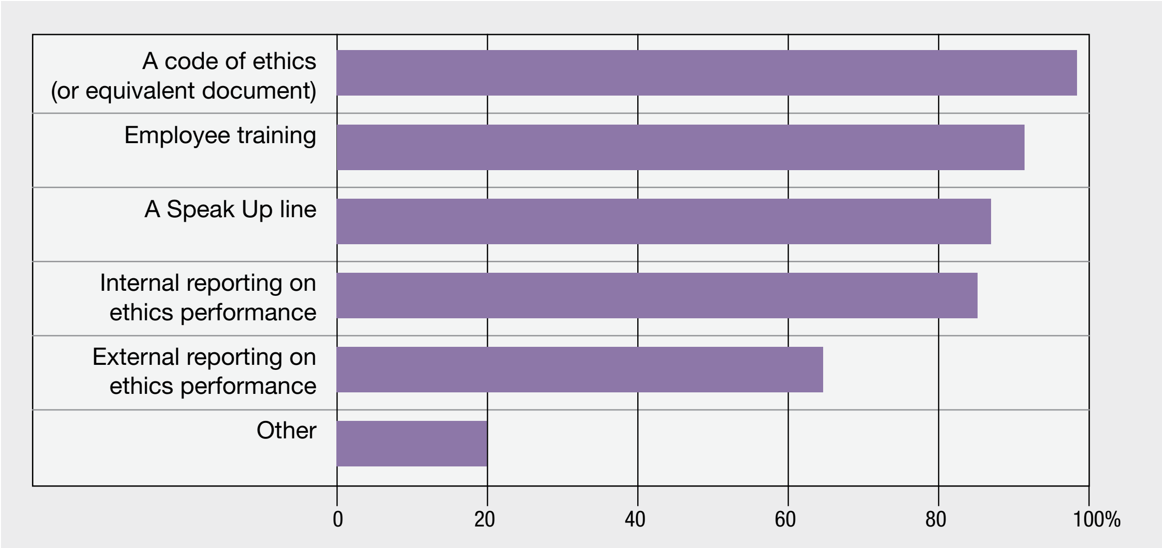
It is also important for directors to get out and about in the company. No one can get a full impression of what is really happening by simply sitting in the boardroom and receiving carefully prepared briefings from management. Directors should also, as one put it, *“get out and kick the tyres.”* It is helpful to meet managers below the senior executive level that habitually interacts with the board. Informal discussion in an offsite setting will yield a useful impression. A programme of rolling visits to all parts of the company's operations is important. These visits should be as informal as possible. Directors will not necessarily learn that much from a carefully staged visit to a subsidiary. Indeed, the sense that the visit is being overly staged is a warning sign in itself.

4.4 Codes of ethics

Most companies now have codes of ethics (sometimes called code of business conduct or similar). To be effective, these need to be owned and supported from the very top. There is no point in having a code if the top management and board either ignore it or flout it. Codes therefore benefit from a personal introduction by the chairman, chief executive, or both, explaining the importance of the code and why it matters to every single employee including them [13].

[12] See www.investinginintegrity.org.uk
[13] See Appendix 3 for examples of chairmen's and chief executives' statements.

Figure 3 The main elements of UK corporate ethics programmes



Source: Institute of Business Ethics *Ethics Policies and Programmes: 2013 UK and Continental European Survey*

Codes need to reflect the values the company has chosen to adopt. A code which is simply a rule book will not achieve this purpose, and a record of compliance will give only limited protection because the code will not cover every situation. A code which is clearly built on values will help employees to make the right choice when they are facing decisions which fall outside specific training. They will face peer pressure to do so if the code is used as a means of cementing values throughout the organisation.

> “ *the code has to be a ‘live’ document*

This means that the code has to be a ‘live’ document and not something which companies simply issue to new employees and then forget about. Making the link between the values of the organisation and the areas covered in the code will root the values in the behaviour expected. Top management need to refer to it regularly, while employees need to be reminded in other ways about its importance to them in the way they do their jobs. This can be done through training sessions, periodic revamps, reference to the code in performance appraisals and the incorporation of behavioural expectations into remuneration arrangements. For example, bonuses can be as dependent on evidence of how the employee has delivered achievements as on the achievements themselves.

Boards need to satisfy themselves that management ensures employees are aware of the code at all times and monitors its impact. One possibility is to ensure that line managers build awareness of the code regularly into such things as team meetings, training and performance appraisal with their direct reports. Directors also need to ensure that information about conformity to the code is drawn regularly to their attention.

Finally, it is increasingly seen as good practice for boards to ensure that their company reports publicly on issues that have arisen during the year. Publication of the numbers of employees who have been dismissed or disciplined for serious infringements of the code may seem to be courting bad publicity. In fact a company's willingness to publish such detail will be seen both as an indication of its seriousness in implementing its code and also as a deterrent to bad behaviour. Employees will know there is a real possibility of sanction if they infringe the code.

While setting values and ensuring management implements them is the responsibility of the whole board, some of the detailed work around codes may be delegated to a special board committee together with a dedicated in-house resource, as noted below. Critically important to the credibility of codes, though, is the involvement of the chairman or chief executive. Some examples of their personal commitment are set out in Appendix 3. These include a couple of unequivocal statements. John McFarlane, Chairman of Aviva, says: *"It's non-negotiable that we should all adhere to this Code."*

4.5 Speak up

According to the Association of Certified Fraud Examiners, just over half of reported fraud within organisations is identified by tip-offs from employees or contractors [14]. This is an important reason why companies should have an effective speak up or whistleblowing system. Board monitoring, both of the design of the system and of key results, is an important tool for testing whether the desired values are embedded within the company.

Among possible problems are that those who speak up are not listened to and can be victimised or ostracised by colleagues, not just management. So people are reluctant to speak up because they are frightened of reprisals, particularly from their immediate colleagues. A typical whistleblower may have only been in the job for less than two years and thus may not be fully integrated in their team. Three quarters are ignored when they first raise an issue, but most will raise it only once. They rarely get feedback, and very rarely are properly looked after by their employer [15].

So speak up arrangements need to be user friendly and confirm a sense of openness. Partly for this reason, best practice is moving away from the term 'whistleblowing' towards expressions like 'speak up' or 'open-door' which appear less like an invitation to tell-tales and more a general willingness on the part of the organisation to hear the concerns of its employees. Also, the term 'speak up' encourages people to intervene before a transgression takes place, whereas the whistle is normally only blown after the event by which time it is too late. Companies need to keep employees aware of their speak up policy, reminding them of it on a fairly regular basis with fresh literature and posters. They need to reach out to those who have raised concerns and, as far as possible, keep them informed of what has happened as a result of their intervention.

[14] Association of Certified Fraud Examiners (2012) *Report to the Nations on Occupational Fraud Abuse*: 2012 Global Fraud Study p16.
[15] Public Concern at Work (2013) *The Whistleblowing Commission: Report on the effectiveness of existing arrangements for workplace whistleblowing in the UK.*

Boards need to know not just about the incidence of speak up or whistleblowing but also what action has been taken when the investigation has been completed. They need to know how many employees claim to have been dismissed after they have raised concerns and what the management has done about this. This should be the subject of regular reports to the board, or at least to a relevant committee. Effective speak up arrangements require resources, and need to include procedures for separating out malpractice from personal issues which should be dealt with by the human resources department. However, the price is widely seen as worth paying. From a director's perspective information on speak up is valuable in understanding where the company really stands, in much the same way as information on customer complaints.

4.6 Board committees for corporate responsibility and ethics

The task of monitoring and challenging standards of behaviour is relevant to a number of board committees. Because the task requires information flows, review of non-financial disclosure in the annual report and involves the management of risk, the audit committee is certainly relevant. Alternatively, it may be allocated to a risk committee if the board has decided to appoint one. Insofar as high standards of behaviour are a requirement on senior executives, the remuneration committee may also be involved. A growing number of companies now have a corporate responsibility committee.

These can play a useful role, so long as it is clearly understood that responsibility for values and culture still resides with the entire board. The corporate responsibility committee must not be a way of pushing core issues to one side so the board can get on with other work and, if the corporate responsibility committee is to deal with values and culture, it must have a remit which ensures that this purpose is clear.

According to some definitions, corporate responsibility is simply about managing non-financial risks by ensuring the company treats its stakeholders well. However, this does not go deep enough. Centrica lays this out clearly in the terms of reference for its Corporate Responsibility Committee when it says the committee is not responsible for the oversight of core health and safety performance and controls across the Group. This remains the responsibility of the Centrica Board and Executive [16].

Given the importance of values and culture and the responsibility of directors for oversight, any committee needs to be populated by main board directors and expected to report back to the full board on a regular basis. It may co-opt executives who are not on the board or invite them to attend on a regular basis, but it should remain capable of operating independently, especially dealing with assurance of relevant information. BAE Systems lays down that its Corporate Responsibility Committee shall have one meeting or part of a meeting each year with its corporate responsibility assurer *"without any executive directors or members of management present,"* and one meeting held jointly with the audit committee as both use the services of internal audit [17]. It should also have powers to seek out information as necessary. Thus Wm Morrison Supermarkets gives its committee explicit right *"to seek any information it requires from any employee of the company in order to perform its duties [18]."*

[16] See the corporate governance section of the company's website www.centrica.com
[17] See the corporate governance section of the company's website www.baesystems.com
[18] See the corporate governance section of the company's website www.morrisons-corporate.com

Among the issues a board-level corporate responsibility committee might include in its remit are:

- Review of the effectiveness of the company's internal controls and procedures for identifying, managing and reporting risks related to all aspects to responsible behaviour, including business ethics. This will normally require working closely with internal audit as well as monitoring the effectiveness of internal audit in this area.

- Appointing and overseeing the work of the entity charged with providing independent assurance of corporate responsibility. This is non-audit work which may not be suitable for the financial auditor.

- Monitoring the implementation and levels of compliance with the company's code of business practice and the extent to which suppliers also conform.

- Ensuring that suitable whistleblowing or speak up arrangements are in place and monitoring their operation.

- Monitoring the integrity of corporate responsibility reporting in the annual report.

5. Decision-making and Conflicts of Interest

Boards may often be called upon to make difficult decisions. Sometimes the simpler the problem sounds the harder it is to come to the right conclusion. In many cases there is no 'right' answer. Boards will find it easier, however, to come to a conclusion if the starting point is a set of well-articulated values on which their deliberation can be based. The company's values and culture will be reinforced if employees can clearly see they have been applied to the decision. A consistent approach is therefore key.

Take, for example, the question of a product recall where a defect is unexpectedly found in one sample which could inflict serious harm to customers if replicated elsewhere. For some companies the choice to withdraw the product and recall those which have been sold may be easy if their customers are not dependent on them for their livelihood. A decision on contaminated food, for example, is relatively obvious and easy. Withdrawing a product may be expensive but it is far less risky to the company's reputation and franchise than allowing the possibility, however remote, of inflicting a serious health problem on one or more customers. The latter have a range of choices. They can switch from meat to fish, for example, or to beer from wine that might be laced with anti-freeze, as once happened in Austria.

> *Integrity is of little value if it is not accompanied by courage, and perhaps the moment where this is most true is where a director stands alone*

The decision is much more difficult when the product in question is an integral part of a piece of equipment on which customers depend for their livelihood and when there is serious doubt about whether the defect is actually systemic or a one-off problem. An example of this dilemma might be a critical aircraft component. Causing all your customers to ground their planes unnecessarily because a problem has been found in one component will wreak serious damage to your business and those of your customers. On the other hand fatalities arising from an accident attributable to a fault that was in fact systemic and should have been detected and dealt with could destroy your own franchise.

Of course the decision requires careful and objective analysis of the facts and expert opinion which will help boards assess the risks, but in the end, the board has to make up its mind. What it decides will clearly be influenced by the mindset with which it approaches the decision. An approach that is looking for compromise will probably produce a poor quality decision. An approach which is genuinely prepared to ground the aircraft if the evidence suggests that this is the right course will produce a better decision. This is not the same as saying that the right decision is to ground the planes. The right decision is the decision made for the right reasons through consistent application of core values.

This may require courage, and the example just cited is not the only one where this applies. Integrity is of little value if it is not accompanied by courage, and perhaps the moment where this is most true is where a director stands alone. Sometimes it will be because they are the only one who can see – or is prepared to articulate – the flawed nature of the consensus to which the board is drifting. Sometimes this will be because the director concerned is wrong. Yet group decisions can easily involve wearing down opposition often by a powerful and overbearing chief executive or chairman, so that gradually a particular choice becomes inevitable. One possibility for a lone dissenter is to register opposition but then eventually side with the crowd. This may do something to salvage a tarnished reputation if the decision turns out to have been a mistake, but it will not stop the damage that arises as a result. Should a director in that position resign rather than give in? The answer is probably yes when all else has failed, but that means also being able to understand what are the decisions that matter so much as to warrant such a dramatic step. It is also never right to give up at the first hurdle. The real skill perhaps lies in being able to influence board members so that the consensus moves away from the rocks. Asking the right questions at an early stage can be very helpful in exposing a flawed strategy.

Tax is another area where boards must make difficult decisions. Such is the complexity of the tax system that companies, especially those operating in several jurisdictions, can virtually decide for themselves how much tax to pay. One approach is to reduce tax to a legal minimum on the basis that this is the company's obligation to the shareholders to whom the company and its assets ultimately belong. Public focus on how much tax companies pay has made this decision more complex, however. There is still no absolute right answer, but boards must be aware of the basis on which they have made the decision and be able to explain it. Again a consistent method based on core values will help this approach. Transactions that are being undertaken purely for tax reasons deserve particular scrutiny because of their potential for reputational damage.

This involves asking questions about whether and how the chosen policy fits in with the company's values, how it fits in with the company's commercial and financial strategy, what are its long term implications and its impact on stakeholders. Just as the business model reflects the values the company has chosen, so do all the decisions the board makes. Having a clearly articulated set of values at the outset will make for consistency and should make complex choices clearer. As one board adviser put it: *"The ethical challenge is meeting the competing interests of all your different stakeholders – and still being able to make money."*

"The ethical challenge is meeting the competing interests of all your different stakeholders – and still being able to make money

5.1 Conflicts of interest

An important duty for boards is addressing conflicts of interest. The OECD assigns an important responsibility to independent directors for addressing situations where there is a potential conflict. The UK Companies Act 2006 says directors should seek to avoid situations in which they may have a direct or indirect interest that conflicts with the interests of the company [19]. The Act talks of situations where the director may have an interest in exploiting a property, opportunity or information in a way that conflicts with his or her obligations to the company. Processes for nominating new directors, and overseeing related party transactions may also involve conflict.

However, conflicts arise frequently and cover a lot of different situations. Thus the OECD notes a series of examples of situations where conflicts may arise. Since boards decide directors' remuneration and directors sit on boards, it is important to have a process in place which ensures that executives do not decide their own remuneration. Similarly, the OECD talks about financial and non-financial reporting. Executives may be tempted to portray the company's results or describe its business in a way that is unduly flattering, or to gloss over or hide problems that have emerged. Beyond that are operational conflicts. Should a company put a customer's interests first or its own? It will be quite clear both to employees and, eventually, also to customers when this has happened. Boards that fail to resolve conflicts fairly or that approach them in a self-interested way are setting an example that could undermine the culture they have been trying to create. Think back to Enron and the board decision to abandon its ethics policy temporarily for the sake of expediency.

All these cases have the potential to undermine trust in the company if they are not handled properly. They are easier to deal with if the company has a clear set of values which ensure that conflicts are resolved in the broader interest of the relevant stakeholders rather than in the narrower interests of the relevant executives. Honesty and transparency are of the essence.

[19] Section 175.1.

Conclusion

This paper has sought to show that setting the right values and culture is integral to a company's success and its ability to generate value over the longer term. As such the task is very much one for boards. This is not necessarily a defensive matter, although companies which ignore it are running a greater risk than those that do not. Rather it is a positive task, which aims to make a business stronger and more sustainable.

Most business leaders are people of principle who apply high standards to themselves, as indeed are most of those that they employ. Directors cannot, however, assume that culture emerges on its own. Companies are living organisms, and those that work in them can face pressures to make decisions they would not encounter in their lives as individuals. Corporate values need therefore to be shaped positively so that the behaviour of the group is consistent both with what society expects and with what individuals expect of themselves and those immediately around them.

This takes us beyond compliance with laws, regulations and governance codes, all of which have an important role to play but none of which are sufficient on their own to deliver the trust on which all companies depend for their continuing franchise. Establishing and maintaining a framework that enables trust to flourish can only be done from the top. It is not only about standards of behaviour but understanding and influencing what drives that behaviour. That requires monitoring of incentives, a rigorous approach to the management of conflicts of interest, and a consistent approach to decision-making.

A patient and thorough effort by directors is required to ensure both that the company has an agreed set of values and that they are driving behaviour throughout the business. However, once the framework is in place, the company is stronger. Its employees should be more committed and motivated because they can be trusted to make the correct decisions, and governments should be happy because businesses that are trusted provide secure jobs and require less regulation.

Appendix 1
What the Law and Regulators Require, What Shareholders Expect

What the law and regulators require

The UK Companies Act 2006 calls on directors to take account of the company's impact on society and not take decisions merely for short term financial advantage.

Section 172 says directors must act in the way they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole. Among other matters, they should have regard to: the likely consequences of any decision in the long term; the interests of the company's employees; the need to foster the company's business relationships with suppliers, customers and others; the impact of the company's operations on the community and the environment; the need to act fairly as between members of the company; and *"the desirability of the company maintaining a reputation for high standards of business conduct".*

While the law thus refers to the desirability of high standards, the **UK Corporate Governance Code** [20] states explicitly that *"the board should set the company's values and standards and ensure that its obligations to shareholders and others are understood and met"*. This is explored in greater detail in the **FRC Guidance on Board Effectiveness**, published in March 2011. Mention of the importance of ethical leadership and values recurs in several places in the guidance. This is set in the context of the many attributes that an effective board requires. The establishment on a values framework is not the only task of a board but it is essential to the delivery of an effective board and a successful company.

Thus the Guidance states that:

> *An effective board should demonstrate ethical leadership, displaying – and promoting throughout the company – behaviour consistent with the culture and values it has defined for the organisation. The chairman, in particular, should demonstrate the highest standards of integrity and probity, and set clear expectations concerning the company's culture and behaviour, and the style and tone of board discussions. Non-executive directors have a responsibility to uphold high standards of integrity and probity. They should support the chairman and executive directors in instilling the appropriate culture, values and behaviour in the boardroom and beyond.*

This message is underpinned by a core statement from the **Organisation for Economic Cooperation and Development** (OECD) [21]. Its Principles of Corporate Governance (2004) are a guiding document for regulators and companies all over the world. They state clearly:

> *The board has a key role in setting the ethical tone of a company, not only by its own actions, but also in appointing and overseeing key executives and consequently the management in general. High ethical standards are in the long term interests of the company as a means to make it credible and trustworthy, not only in day-to-day operations but also with respect to longer term commitments.*

[20] See www.frc.org.uk
[21] See www.oecd.org/daf/ca/oecdprinciplesofcorporategovernance.htm

The OECD goes on to say that company-wide codes of conduct may be useful *"as a standard for conduct by both the board and key executives, setting the framework for the exercise of judgement in dealing with varying and often conflicting constituencies. At a minimum, the ethical code should set clear limits on the pursuit of private interests."*

"An overall framework for ethical conduct goes beyond compliance with the law, which should always be a fundamental requirement," it concludes.

What investors expect

The **International Corporate Governance Network** (ICGN) [22] is the leading global organisation representing the views of long term investors. Its views carry weight with regulators and policy-makers such as the US Securities and Exchange Commission and the European Commission because they recognise that the ICGN bases its statements on international consensus which has become increasingly important as markets have become more international.

The ICGN Global Corporate Governance Principles: Revised (2009) lay down the expectations of investors. Its section on corporate culture is set in the context of a range of principles aimed at generating long-term value and sustainable companies. The ICGN says:

> *Companies should engender a corporate culture which ensures that employees understand their responsibility for appropriate behaviour. The board should seek actively to cultivate and sustain an ethical corporate culture. The company should take active measures to ensure that its ethical standards are adhered to in all aspects of its business. The board is responsible for overseeing the implementation and maintenance of a culture of integrity.*

Among issues, which it highlights, are director conflicts of interest, bribery and corruption, employee share dealing and whistleblowing. It says the *"board should ensure that the company has in place a mechanism whereby an employee, supplier or other stakeholder can, without fear of retribution, raise issues of particular concern with regard to potential or suspected breaches of a company's code of ethics or conduct."*

Some individual investment firms have also begun to spell out their expectations with regard to the values of companies in which they hold stakes. One such is **Standard Life Investments**, which manages £179bn on behalf of institutional and retail clients as well as its own insurance parent [23]. It is thus an important mainstream investor. In its latest Corporate Governance Principles, it says:

> *We believe that a company run in the long-term interests of its shareholders should have values that respect its responsibilities to not only its employees, suppliers and customers but also the environment and society as a whole. Also, that it should adopt business practices throughout the company which are consistent with its values.*

[22] See: www.icgn.org
[23] As of June 2013.

We expect the board to determine the company's values in a thoughtful manner so that they are specific to the company and capable of implementation and monitoring by the board at regular intervals. Furthermore we look to the board to set and be seen to set the right tone from the top, consistent with upholding the values throughout the company over the long-term.

There should be effective mechanisms to ensure that critical issues that may affect adversely the company's financial position, reputation and risk profile are escalated to the board's attention in an efficient and timely manner. Each year the board should acknowledge in the annual report its responsibility for determining and maintaining the company's values, and ensuring that they are reflected in the company's business practices. It should provide an explanatory and meaningful account of how it has fulfilled these responsibilities.

Standard Life's approach is more explicit than most, but it is echoed by **Legal & General Investment Management** (LGIM) with £443bn under management and which is one of the largest holders of UK equities [24]. It says *"boards of companies in which it invests need to communicate the core values of the business throughout the company and to its shareholders."*

Some companies may choose to have a corporate responsibility, ethics or sustainability committee, it says, and it is supportive of this.

LGIM considers such a committee to be essential for companies which are particularly exposed to social and environmental risks that can harm operational integrity over the long term. The committee should not only stay informed of external developments, but should also ensure that risks and opportunities identified in the committee meetings are embedded into the company's overall strategy to help build a sustainable business model for the company.

Another leading investor, Helena Morrissey, Chief Executive of Newton Investment Management, puts it as follows [25]:

Much of the UK fund management industry now regards strong, positive culture as inextricably linked to delivering good long-term returns for our clients. That's a rational view based on performance – including the painful experiences of investing in the companies that get it wrong, whether those misdemeanours are flagrant violations of the law or taking customers for granted.

[24] As of September 2013.
[25] *Sunday Telegraph,* January 12 2014, 'A new voice for investors to drive culture change'.

Appendix 2
What Companies Currently Do

The Keldeep study listed measures taken by companies to embed values. The tables below show which were most commonly adopted by the 29 leading companies which participated in its research.

There is a striking difference between the universality of companies with codes of conduct and those which profess to have a set of values. Some codes of conduct are purely based on compliance, but embedding values is separate from the business of enforcing compliance with a rulebook. Employees who have absorbed the company's values are more likely to make the correct choices when confronted with situations that are not directly covered by the rules.

It is also worth noting the relatively low incidence of ethical audits. One problem here may be the difficulty in quantifying the degree to which ethical values are implanted in the organisation.

Box 3 Measures taken to embed ethical values

Input measures	% of companies
The company has a set of values	85
The company has a code of conduct	100
The company trains its people in the values	77
The company trains its people in its code of conduct	96
The company trains people regularly in ethical matters	85
The company evaluates its people for their ethics or adherence to the company values	81
The company has a whistleblowing policy	100
The company conducts occasional ethics audits	35
There are questions on ethics and values in the employee survey	77
Output measures	
Outcomes from employee surveys inform board action	88
Individual manager targets are determined from employee surveys	52
Managers with less than perfect ratings on ethics and values are tracked	48
The number of ethical incidents is tracked	92
The locations / countries / business units with ethical incidents are tracked	92
Results from ethical audits are reported	35
The amount and value of business turned away due to ethical concerns is tracked	48

Source: Muir I (2013) *The Tone from The Top,* Keldeep Associates

Appendix 3
Codes are Best Owned from the Top

Below are some examples of the way chief executives and chairmen have introduced the code of practice to their colleagues.

Tate & Lyle Code of Ethics (2013)

Do what is right, no matter what

In business and in life in general there are often temptations to take a 'shorter route'; to be 'a little flexible'; to be 'pragmatic' – these are usually euphemisms for compromising integrity. When times are good, it is easy to ignore such temptations. But when the pressure is on and there are demanding targets to be met, there can be a temptation to 'get there' by compromising standards.

It is never worth it.

At Tate & Lyle we believe in doing what is right, no matter what.
Most of the time we know instinctively what is right and what is not.
Our general rule is, if something doesn't feel right, don't do it. But sometimes there can be grey areas, and if you are unsure, you must ask. And if you see something that looks wrong, you must report it.

This Code of Ethics is a guide to help you do business the right way.
Please read it carefully so you understand what is required of us all as employees and business partners of Tate & Lyle.

Integrity is one of our Core Values, and we must never compromise it.

Javed Ahmed
Chief Executive

[26] Diageo's letter, reproduced on the opposite page, is personally signed by the CEO and every member of the Executive Committee. Diageo's Executive Committee is different from the Company's Board of Directors. Only two of the signatories on the letter - the CEO (Ivan Menezes) and CFO (Deirdre Mahlan) - sit on the Board. As the primary audience for Diageo's Code of Business Conduct is the Company's employees, it was felt that a statement of intent from the Executive would have more resonance with employees. The personal signature of the CEO underlines personal commitment.

Diageo Code of Business Conduct (2013) [26]

Letter from the Executive Committee

Our purpose and values define the way we work together and perform as a business. We want to constantly demonstrate our commitment to being one of the world's most trusted and respected companies. We ask our customers, consumers, shareholders, governments and the communities in which we operate, to trust that we understand our responsibility as the world's leading premium drinks business and that we behave accordingly.

Our reputation is critical to our long-term commercial success. We all have a responsibility to ensure we strive to do the right thing and in so doing, protect that reputation and fulfil our purpose of celebrating life every day, everywhere. In today's connected world our individual actions have the potential to impact Diageo globally, both positively and negatively. All of us have an obligation to apply our Code of Business Conduct (our Code), policies and standards, and all relevant laws, in everything we do.

This version of our Code makes a stronger link to our values and has been updated to align to our new simplified policies as well as introducing a new consolidated section on anti-corruption.

However, our Code cannot address every situation we may face and it is not a substitute for applying common sense and good judgement. We have therefore also created a new section 'Doing the right thing' as a guide to help you when you are faced with a dilemma where there are not prescribed rules to follow. When in doubt, always seek advice; talk to your colleagues to get their perspective, or speak to your line manager, local CC&E Manager, the Global Compliance & Ethics team or an expert from the appropriate function.
If you are concerned about something that does not appear to support our purpose and values or contravenes the law, our Code, policies or standards, you should speak up. There may be circumstances in which you may wish to use the independent SpeakUp service, where you can raise an issue or concern confidentially. We will not tolerate any retaliation against an individual for raising a concern or making a report in good faith.

We want Diageo to be recognised as a great place to work. Most of all, however, we want Diageo to become a by-word for acting with integrity and responsibility; a business with values that are demonstrated every day and are deeply embedded in the fabric of our organisation.

Please take the time to read and understand our Code. Please also personally commit to implementing it in all of your actions and all of our business activities. We know that we have your full support for the values that have set Diageo apart from the competition. Thank you.

Ivan M Menezes
Chief Executive Officer

Aviva Business Ethics Code (2013)

A message from John McFarlane, Chairman, Aviva

I have something really important to ask of everyone at Aviva.

Our purpose is 'we free people from fear of uncertainty'. By acting responsibly in the way we do business we will ensure that we are around for the long term to deliver on this commitment.

Our Business Ethics Code sets out the standards for the way we work. The Code provides a practical set of principles as a centre of gravity to help us make everyday decisions and guide our actions. Committing to these standards and practices gives us the best possible chance that we will be trusted and respected.

Our reputation significantly influences whether customers and business partners do business with us, whether our people will invest their working lives in us, why investors decide to own or sell our stock and securities, and whether or not the community should trust us.

It is non-negotiable that we should all adhere to this Code. While it provides guidance, it cannot cover every circumstance we may face. To help everyone, we provide examples of its application, however if you are in any doubt regarding the interpretation or application of the Code, please consult your manager in the first instance.

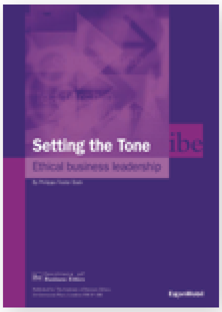
No one will be criticised for any loss of business which may result from adherence to the Code. Equally, no staff member will be prejudiced as a consequence of reporting a breach or suspected breach of the standards. I therefore encourage everyone to report genuinely held concerns about any behaviour or decisions which are perceived to be unethical and in contravention of the Code.

I would appreciate it, if you could take the time to familiarise yourself with the Code and if you have any questions please raise them with your manager or the Group Corporate Responsibility director.

IBE Publications Related to this Topic

IBE publications provide thought leadership and practical guidance to those involved in developing and promoting business ethics, including senior business people, corporate governance professionals and ethics and compliance practitioners.

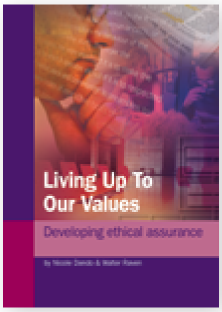
Some recent publications related to this topic which you might be interested in include:



Setting the Tone: ethical business leadership

Philippa Foster Back CBE

Leadership is essential to business ethics, as ethical qualities are essential to good leadership. This report demonstrates that business leaders should consider ethical competence as a core part of their business acumen and provides guidance to those wishing to build a culture of trust and accountability and strengthen the ethical aspirations of their organisation. It includes interviews with business leaders offering practical insights into ethical leadership issues.

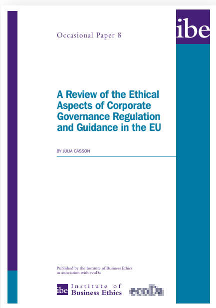


Living Up To Our Values: developing ethical assurance

Nicole Dando & Walter Raven

How can boards be confident that their organisation is living up to its ethical values and commitments?

This report provides a practical framework for approaching the assurance of ethical performance against an organisation's own code of ethics. It is addressed to those at board level overseeing assurance that ethical values are embedded, that commitments are being met and management processes are effective. It will assist assurance professionals seeking to broaden their understanding of non-financial issues and is intended as an aid to the development of good practice.

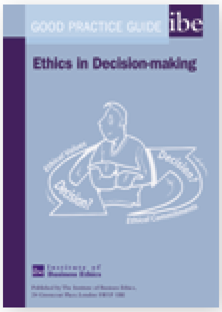


A Review of the Ethical Aspects of Corporate Governance Regulation and Guidance in the EU

Julia Casson

This paper explores the extent to which, in legislation, frameworks and codes for corporate governance across the EU and within its member states, there are explicit statements or requirements for business to be governed in line with ethical principles or commitments.

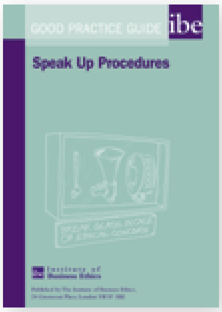
This report will be relevant to those interested in the evolving debate around culture and behaviour in business, and those concerned with the development of corporate governance and responsible business practice.



Ethics in Decision-making

David Barr and Chris Campbell with Nicole Dando

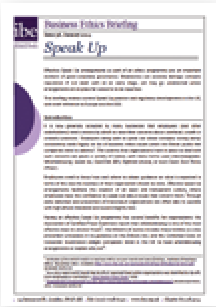
Drawing on experiences of UK and international companies, Ethics in Decision-making provides a framework for understanding the key conditions for and barriers to bringing ethics into business decision-making. This Guide will help organisations embed ethical considerations through all their decision-making processes. It includes examples of how companies facilitate and promote this for employees, managers and senior leaders.



Speak Up Procedures

Ed. Katherine Bradshaw

Drawing on the experiences of international and UK companies, this practical guide outlines why organisations need to encourage and support staff to make enquiries on ethical issues, raise concerns and report misconduct; provides guidance on what to consider when establishing a Speak Up policy and the procedures to implement it and suggests how to operate the policy effectively, from providing training to handling and investigating calls to Speak Up lines.



Speak Up

IBE Business Ethics Briefing

Effective Speak Up arrangements as part of an ethics programme are an important component of good corporate governance. Malpractice can severely damage company reputation if not dealt with at an early stage, yet may go undetected unless arrangements are in place for concerns to be reported. This briefing reviews current Speak Up practice and regulatory developments in the UK, with brief reference to Europe and the USA.

Business Ethics Committees

IBE Business Ethics Briefing

How do organisations govern their ethical standards? This Briefing considers the terms of reference and good practice for a board committee with ultimate responsibility for ethical values and business conduct.

Investing in Integrity

Is there a way to prove a company's integrity?

The IBE has developed a charter mark in association with Chartered Institute of Securities and Investment (CISI) to help businesses and organisations know if their ethics programme is embedded throughout their organisation.
www.investinginintegrity.org.uk

Our publications are available from www.ibe.org.uk/list-of-publications/67/47

Institute of Business Ethics

The Institute of Business Ethics was established in 1986 to encourage high standards of corporate and business behaviour and the sharing of best practice.

www.ibe.org.uk

Ethics, Risk and Governance: a board briefing paper

One of the lessons of the 2008 banking crisis has been that ethics matters to business, both in terms of its reputation and its sustainability.

Setting the right values and culture is integral to a company's success and its ability to generate value over the longer term. The challenge for business is how to develop and embed real values. This requires leadership and is a core task for boards. Many boards acknowledge the importance of a healthy corporate culture, both because of the role this plays in mitigating risk and because of the value to their franchise of a sound reputation.

This paper sets out why directors need to be actively involved in setting and maintaining a company's ethical values and suggests some ways to approach it. It aims to help directors define their contribution to the maintenance of sound values and culture.

Institute of Business Ethics

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