Report of a senior practitioners' workshop on identifying indicators of corporate culture

Sponsored by the International Corporate Governance Network(ICGN), Institute of Business Ethics(IBE) and Institute of Chartered Secretaries and Administrators(ICSA) and held on December 17, 2015

Introduction and background

The financial crisis and a succession of corporate scandals, culminating in the emissions crisis at Volkswagen, have focused attention on corporate culture. Regulators and policymakers have come to appreciate that a rules-based compliance approach will not, on its own, deliver healthy behaviour. This is because behaviour is determined not only by rules but also by the culture of the entity concerned – and in the worse cases, of course, the culture can be one of wilfully ignoring and seeking to bypass rules.

This calls, on the one hand, for a positive approach, involving a quest for ways of promoting a healthy culture which will reduce risk and reinforce sustainable value creation. On the other, it suggests a need to identify signs of a weakening culture at an early stage. The answer to corporate scandals - and the loss of trust in business they engender - is not necessarily to add more regulation, but to learn how to build strong corporate cultures which afford protection against disaster. One of the important aims of the discussion was, therefore, to identify indicators of both good and poor cultures (see Appendix 1 which lists a broad range of factors that came up in the discussion).

The workshop did not set out to generate a template for the ideal corporate culture. Rather, its purpose was to bring together people from a range of different disciplines – corporate, investor and regulatory – to deepen collective understanding of what drives culture within a business. Examples of a good culture were companies with a well-articulated set of values clearly owned by the board and senior executive, companies displaying a strong tone from the top in a behavioural sense, and companies with codes of conduct informed by their values and with good arrangements for monitoring compliance.

This report outlines the discussion and the main conclusions. In summary participants found that:

- Good corporate governance is critical but there should be a broader view of what this means. Directors are more easily able than outsiders, including shareholders and regulators, to perceive when something is wrong but this requires a high level of engagement and perhaps less focus merely on the processes of the board itself. Boards should see that good governance runs through all areas of the company, including the executive committee, which has not traditionally been a focus of attention. There should be clear lines of authority and structure, and openness to challenge at every level. Also, directors should ensure they are aware of the customer experience.
- Transparency and openness matter. A good culture means being able to discuss difficult issues. Tasks include strengthening talent spotting, getting the most out of annual employee surveys, board contact with those that directly supervise employees at shop floor level, securing an adequate budget for education and training and fairness in remuneration. Good metrics are needed. Chief Executives should regularly discuss these with the board.
- The role of human resources, ethics officers and internal audit should be strengthened. HR is not responsible for making decisions about or defining the desired culture as this is the role of the Board, but it does determine how the culture is embedded and so deserves attention. A good speak-up or whistle-blowing arrangement is essential, and needs to be independently run. Internal audit, meanwhile, is well placed to detect when culture is slipping. Investors and regulators should enquire more frequently about developments in all these areas.

<u>What we mean by culture</u>

The group did not set out to define culture, but it was generally accepted that the term refers to the type of behaviours which a company will promote and encourage and those that it will not tolerate. The determination of such behaviour depends to a great extent on the values set and practiced by the board and top management, as well as their cascading through the organisation.

Much of the discussion focused on how to ensure that the right drivers of behaviour are in place and how to identify and address situations where there is a discrepancy between board, top management and external stakeholder expectations and actual practice within the organisation.

Such a discrepancy is an important risk factor, while, conversely, a strong culture helps promote sustainable long term financial success. From this perspective, a focus on culture should not merely be about identifying outliers at risk of disaster, but of boosting the longer-term performance of mediocre or moribund companies.

- There is a connection between lax financial discipline, for example, a propensity to excessive gearing or failure to undertake proper due diligence in a takeover, and broader cultural weakness. This may manifest itself in other ways, for example fraud and malpractice by individual employees.

Causes of bad behaviour

The discussion identified three main drivers of bad behaviour: corporate stress which led people to take short cuts, excessive focus on short term financial targets which might of itself become a source of stress, and a ready tolerance of small breaches of the rules which allowed misdemeanour to become incremental.

Corporate stress was seen as a core issue. Participants felt that any company under stress could cut corners and make mistakes. If the board was dysfunctional, it would not detect this or be able to deal with it.

One participant said that all companies were facing stress as a result of globalisation. Stress could be positive if it enabled companies to prosper in highly competitive markets. Sometimes it is the result of external factors, like a drop in the oil price. Yet if stress cannot be avoided, the way boards deal with it makes a significant difference. Others said that the particular danger was when stress was self-induced as a result of poor judgement. Volkswagen had imposed stress on itself by seeking to become the world's number one car maker when its workforce was twice as large as that of Toyota. The bonus culture in banks had created stress. It had led banks to worry about their ability to attract talent and pushed customer satisfaction into second place.

An autocratic chief executive was likely to be a cause of stress as was the emphasis on achieving demanding short term financial targets, especially when these were accompanied by a threat of sanctions if they were not met. In the latter case the market was seen as imposing stress on companies.

One participant said an autocratic chief executive and or unrealistic targets could exacerbate a rift between staff and management. In these cases the board was often unable to get an accurate picture of what was going on. Information was summarised and sanitised before it reached directors. Staff at such institutions had reported that, while they individually wanted to do a good job, the pressures sometimes led them to adopt a different persona as group behaviour took over.

Another risk factor identified by the group was tolerance of breaches of the rules and accepted best practice, or a tendency to push at the limit of what was permitted by the rules or regulations[1]. This could be seen for example in poorly implemented corporate

[1] An example was given in the background note prepared by the IBE. It read:
"A flawed culture may build up over a long period. As far back as 2010, Citibank produced a brokers' note on Tesco which showed how it was maximising the choices available under IFRS to flatter its results. For example

codes of conduct and in a hostile attitude to regulators. One problem was the incremental nature of bad behaviour. People can rationalise small breaches, and do not even necessarily think they are doing anything wrong. Slippages on issues like disclosure, expense accounts and materiality could lead, over time, to acceptance of more serious lapses. Even when these were large, they might be readily justified. One participant knew of a situation where senior employees of a company were using the corporate jet for personal purposes, but the board of the company did not want to react because the individuals in question were working very hard.

The danger in these cases is the defence that 'everybody is doing it'. This is a strong warning sign and can be true within the company or within a whole sector. A particular problem facing the banks was that the culture deteriorated across the sector. Boards and managements found it difficult to resist the pressure to enter risky business because their employees wanted to benefit from the associated bonuses and because their failure to do so might be taken by the market as a lack of determination to compete.

Some participants argued strongly that the authorities should be tougher in punishing individuals who had clearly broken established rules. This was seen as more appropriate than large fines on institutions. Participants felt there was still need for care. Rigid enforcement of rules and regulations and a policy of severe individual sanctions at corporate level might increase the propensity to bad behaviour. People would become anxious about sanctions and more likely to cover up any lapses rather than deal with them openly. Rather it was a question of inculcating the right mindset among individuals at every level in the company. There needed to be a willing acceptance of the desired standards. This could be achieved by example from the top and also by a careful effort to embed the chosen values. This was part of the broader task of corporate governance.

Other warning signs

Some phenomena provide a useful warning sign of a flawed culture, even though they are more symptoms rather than a root cause. Four were identified in the discussion and in the background material provided to the group: flawed executive remuneration practices; complex legal structures; a tendency for takeovers to proliferate; and lax financial discipline. While these may be indicators of a deeper cultural problem, they should not on their own be taken to mean that such a problem definitely exists.

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it was capitalising interest on store development at £155m whereas Sainsbury was capitalising only £15m and the much bigger Walmart at £57m. This was all perfectly legal. With hindsight, though, one has to ask about the impact on culture. Did what started as an aggressive accounting approach create a permissive culture that meant some executives were more easily driven to outright cheating as the pressures rose on the company?"

- Remuneration provides one of the most public areas of confrontation between companies and their shareholders, and, according to opinion surveys commissioned by the Institute of Business Ethics, it remains the second largest matter of public concern about business after taxation. However, such outright confrontation is relatively rare in proportion to the number of listed companies. What is noticeable is that sometimes problems tend to recur year after year. This can be a sign that all is not well with the culture. The remuneration policies of all the banks which failed in the UK during the financial crisis had received several red or at least amber tops from the Association of British Insurers' voting service.
- Complex legal structures make it hard for boards and management to track what is going on in the company. In some cases this can be a deliberate ploy to disguise the truth from the outside world, especially where, as has been seen in some cases in the mining sector, there is also a complex shareholding structure. But this is also true of other companies with what appears to be a simpler corporate model. One participant cited the number of subsidiary boards in the VW group as an example of such complexity. It made it harder for the group board to know what was going on. Thus one problem was opacity. "We can't know what we don't know," one participant said, citing the surprise announcements by Shell that it had misreported its reserves figure and by VW about emissions cheating.
- A poorly implemented takeover can lead to a multiplicity of cultures within the same group. As with complex legal structures there is then a risk of silos and of a pocket of bad culture emerging or thriving beyond the purview of the group board.
- Finally, lax financial discipline can also be a sign of a weak overall culture. One participant said corporate crises have a number of common factors, of which the most important is excess leverage, something which also applies to countries in crisis. Northern Rock was a good case study. The bank was making obvious mistakes, not only as regards the level of leverage but how it was being applied. At RBS leverage also went through the roof.

  RBS failed to do comprehensive due diligence on its merger with ABN-AMRO. That was also a warning factor, this participant said. Investors should make sure that the risk management systems are transparent.

New challenges for governance

One participant said there was a danger of the culture tail wagging the dog. A healthy culture did not lead to strong governance but strong governance was essential to a healthy culture. Others agreed that the critical requirement was focus on developing the governance agenda. This point should be reinforced. Investors should spend more time with directors, another added.

As to how the governance agenda should evolve, there was general agreement that effective boards should be directly engaged in what happened within the company, and in the way staff were treated and motivated. There need to be shared values, a common purpose and consensus among employees about what was expected of them. Also boards can easily become remote from customers. They need to be aware of what the customer is experiencing.

Without these factors it is easy for companies to be vulnerable to a sense of drift.

One participant said it was critical for directors to talk to what he called the first line of supervision – employees responsible for managing teams on the shop floor. These people were well aware of the corporate culture. They knew whether the culture was open, the accountability lines clear and whether the workforce was motivated.

A good question to ask such people was: what major management problems the company was facing and how long it would take to fix them? If the answer was ten years, there was a culture problem within the company. Directors would not be aware of such a situation if they took a hierarchical approach and relied solely on contacts with top management, or even if they just relied on union representatives for a view of what employees were thinking. Management information to the board was inevitably summarised and could be sanitised to disguise the existence of real issues. Open communication across the business was important. It sometimes happened that material issues were suppressed on the grounds that they were personal not business. This should be avoided.

Investors should, therefore, ask directors what other information they relied on besides what they received from management. It was suggested that the governance of how people are managed needs to be a board oversight task. This meant that the employee survey was vital. It should ask whether the right people get promoted within the company and whether staff feel they can speak up.

Participants said the governance of the Executive Committee was as important as the governance of the board itself. It was very important for independent directors to get a good idea of how the executive committee functioned.

One investor said the chief executive retained an overriding influence on culture. He or she determines the culture and builds the board round that. Too often, shareholders were expecting a board to act on their behalf, but this did not happen because the board was set up to shrink from challenge. It was therefore important to get behind the board recruitment process. Another investor cited cases where the company fulfilled the requirements of the UK governance code but had poor governance in practice, but it was very difficult to deal with this because the chairman was weak.

Shareholders needed to get under the surface and judge whether the people were effective. Dialogue with boards could focus on the business model which needed to be properly disclosed.

Corporate participants said that sometimes chairmen ran boards in such a way as to deflect challenge. Also, directors were overloaded. Practicising executives were potentially useful on boards, but their time was limited, especially in financial services companies where the regulatory burden was large. Ways should be found to spread the load.

Insofar as the culture debate is setting a new agenda for boards, this should be reflected in board evaluation processes. These had improved, even though companies were uncertain about how much to report.

Critical functions

The discussion identified three particular pressure points: the role of human resources, internal audit, the speak-up or whistle blowing process. In addition participants raised questions about the role of external auditors.

- **Human resources.** Human resource departments were perceived by many participants as weak and neglected by boards and management. One said they were not delivering the right information. Another said that effective HR departments could and should deliver strategy, structure and people development. Their role should be enhanced but they need to be set up appropriately.

  That meant being responsible for a framework of incentives designed to support strategic objectives across the organisation. This is not just a matter of remuneration and benefits but involved a broader approach to the recognition of good behaviour. Human resource departments should ensure that corporate codes of behaviour were tightly related to people development.

  Some felt that HR directors should attend strategy meetings, but participants also questioned whether HR should have a decision-making role. Its task was to help ensure the desired culture was embedded. Defining the culture was a matter for boards, but it was important for boards and top management, especially the Chief Executive Officer, to pay attention to the role of HR in embedding culture.

  Also HR should not work in isolation. Responsibility for a healthy corporate culture should not be confined and segregated to a formal HR function. It was integral to the work of every executive. Also one participant said that HR was not always trusted by the employees as it was perceived as being on the side of management. If this was the case, a separate ethics officer could fulfil the tasks outlined above.

- Participants agreed that **internal audit** also had an important role to play. Internal auditors were increasingly looking at indicators of culture such as exit interviews and employee engagement surveys. They also examined the micro-cultures within the company. This provided potentially valuable information to the board, but the development of their work had further to go and it was important that internal auditors should not fear losing their jobs as a result of what they report. Their mandate should confirm their independence.

- There was general agreement that the organisation of **speak-up or whistle-blowing arrangements** were highly important, though the existence of such arrangements was not a substitute for an open culture throughout the company. Boards need reliable and regular information about how they are being used and the issues raised. A trusted and independent company secretary could be an important additional conduit for those wishing to raise concerns.

  Getting employees to speak up is difficult. They may be worried about not being able to provide proof of their allegations, driven by team loyalty and worried about bullying. A culture of no-retaliation was an important part of a successful speak-up arrangement. Employee surveys should ask employees whether they feared retaliation if they raised issues of concern.

  Another problem was that most whistle-blowers have been in their jobs for less than two years. Longer standing employees tend to be more caught up in questionable practices or have reasons – including team loyalty - not to raise their heads above the parapets. Frequently there is no response when they do raise their voice. Participants said it is important that speak-up arrangements are properly independent and not run by HR which employees see as part of management.

  Finally, middle management should receive training in speak-up and how to respond to employees who raised issues. Frequently they lack the skills to do so.

- Some participants felt that **external auditors** should play a larger part in analysing culture and reporting back on it, both to boards and regulators. The auditors' own governance was unsatisfactory, one participant said.

  Others said the UK had already sought to raise the bar for auditors, despite the fact that they form a very strong lobby group and are supported by business which wants to keep audit costs down. The UK has the most transparent audit inspection regime in the world, and an audit firm governance code which encourages them to hire independent directors. Many auditors say they give informal feedback on culture to audit committees.

Conclusion

The conclusion that culture matters is a problematic one for regulators because it involves a qualitative approach. They cannot force companies to have a “good” culture because they cannot define exactly what that means and measure compliance on an objective basis. But if they ask why otherwise law-abiding bankers rigged interest rates or automotive engineers cheated on emissions test, they cannot escape the conclusion that there was something in the culture around them that permitted or even encouraged such dishonesty.

It follows that, although they cannot prescribe culture, regulators have an interest in being able to assess it as part of a risk-based approach. This interest is shared by shareholders and debt holders who have investments at stake and by boards and top managers wanting to manage and reduce risk, though their priorities are not necessarily identical.

The discussion outlined above is designed to help all participants get a more effective understanding of what culture entails and how to identify its hallmarks, good and bad.

Time and again the discussion came back to the quality of governance, but participants agreed that governance needs to move beyond processes to the substance of what boards actually do, who they engage with and what questions they ask. Also, it is important not to confuse governance with management. The latter has a critical role in defining and embedding culture. Boards and management need to be clear what their respective responsibilities are and ensure that they complement each other.

Culture and risk

Strengthening corporate culture is increasingly seen as a means of reducing risk, especially by regulators whose primary focus is to protect the market and the public from corporate “disasters.” Yet reducing risk in this way does not automatically lead to value creation. High risk that is understood and managed well can sometimes be justified on the basis that it has the potential to bring high reward. This is where the interests of managers, investors and regulators may diverge. High risk/high reward strategies make regulators nervous. The key question is whether risks, including behavioural risks, are understood and well managed.

The key challenge is to understand what in practice is driving the behaviour of employees and shape those drivers to give greater sustainability and reduce the risk of shock.

The discussion also threw up a number of useful indicators, which may not be conclusive on their own but which, in aggregate, can give a clear indication of culture.

On its own, a strong culture based on openness and respect is not sufficient for success. While it can mitigate conduct risk, it does not guarantee strong business performance. Other values may be needed to augment this, but business values still need to embody a positive impact on culture. Thus a focus on innovation may be positive, whereas a focus on seeking pricing power by exploiting increased market share may not.

Joining up culture with the values needed to deliver performance brings the discussion back to the business model. How the company makes its money will always reflect the core values of those in charge. An overarching requirement may be to encourage companies to be more articulate in describing their business models. Then, as the underlying values become apparent, a judgement can be made on the culture and sustainability of the business and also on its prospects for performance.

This leads on to a final point, which is that there will sometimes be a tension between expectations of short-term returns and the long term sustainability that is delivered by healthy values and culture. This is especially true when companies are operating in extremely competitive markets where others are behaving badly. So the question of whether lower short term returns are compensated for by the reduction in risk is an important one – even though it goes beyond the immediate objectives of the session.

Appendix 1

What can we measure? Indicators of culture

Indicators of culture fall into two types, those to which a numerical measure or can apply or where there is objective factual evidence, and those which are about process. The latter require judgement. Boards, shareholders, and regulators may need to probe, but, by asking the right questions about processes, they should be able to form a view about culture.

While some of these indicators are warning signs of a poor culture, a number of them can also confirm a strong culture. Also any one indicator on its own may not provide a meaningful picture. For example, deviation from the one share-one-vote principle can be a sign of a poor culture, but many family firms with such arrangements have a very good culture. It is important not to rely on one indicator. The overall score will be revealing.

The following is a list of indicators that came up in the discussion.

Quantitative or factual

Competition rules infringements
Customer satisfaction data
Health and safety record over time (including near misses)
Public commitment to values by leadership
Qualified audit reports
Regulatory sanctions
Shareholders contesting remuneration
Staff satisfaction (employee engagement survey)
Speak-up/whistle-blowing statistics
Staff turnover

Processes (in place or not/effective or not)

Aggressive tax policies
Board effectiveness reviews
Consistent application of code of conduct
Complex legal and/or management structure obscuring accountability lines
Due diligence in acquisitions and record of integrating them
Dysfunctional board
Equal treatment of shareholders
Embedding of code of conduct (training of all employees)
Entrenchment of board and/or management
Engaged directors, having first-hand familiarity with operational level
Independent speak-up or whistle-blowing arrangements with feedback to board
Internal audit/ board monitoring of exit interviews
Open culture in which staff at all levels feel free to speak up about concerns
Over-ambitious targets set by management
Overbearing chief executive
Propensity for gearing to increase or for excessive gearing compared to peers
Recruitment policies consistent with declared values
Regular review of code of conduct
Remuneration and incentives at all levels consistent with declared values
Status of internal audit
Succession planning
Tolerance of minor regulatory or code breaches by star employees
Training of middle management in handling speak-up or whistle blowing
Transparent and robust risk management systems

Appendix 2

List of participants

The discussion was held under the Chatham House rule which means that no remark can be attributed to any individual. The sponsoring organisations are grateful to the participants who were as follows:

Meeting Chair: Paul Coombes, Chairman, Centre for Corporate Governance, London Business School

Rapporteur: Peter Montagnon, Associate Director, Institute of Business Ethics and Chair ICGN Business Ethics Committee

Participants:

George Dallas, Policy Director, International Corporate Governance Network; Sir John Egan, former chairman Severn Trent and former Chief Executive of Jaguar Cars and BAA; Philippa Foster Back. Director, Institute of Business Ethics; Deborah Gilshan, Head of Sustainable Ownership, Railpen Investments, Member ICGN Business Ethics Committee; David Jackson, Company Secretary BP; Paul Lee, Head of Corporate Governance, Aberdeen Asset Management; Margaret Foran, Chief Governance Office, VP and Corporate Secretary, Prudential Financial and Member ICGN Risk Oversight Committee; Gavin Grant, Norges Bank Investment Management; Melanie McLaren, Codes and Standards Director, Financial Reporting Council; Stilpon Nestor, Principal, Nestor Advisers, Member ICGN Risk Oversight Committee; Robert Parker, Senior Adviser, Credit Suisse; Anthony Salz, Executive Vice Chairman, NM Rothschild & Sons and Head, Independent Review of Barclays Business Practices; Carol Sergeant, Director, den Danske Bank, Chair Public Concern at Work; Anita Skipper, Aviva Investors; John Sutherland, Senior Adviser, Prudential Regulation Authority; Peter Swabey, Policy and Research Director, Institute of Chartered Secretaries and Administrators; Susan Swabey, Company Secretary, Smith & Nephew; Yvonne Tabron, Head Internal Audit, Tate & Lyle; Trelawny Williams, Fidelity International; David Wright, Secretary General, IOSCO