Setting the Tone...

A Boardroom Guide

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Introduction

It doesn't matter whether it is Enron, Volkswagen, Wells Fargo or any other corporate governance failure or scandal you care to think of. The same questions inevitably arise from stakeholders, whether they are analysts, regulators, investors or even employees. Where was the board? What was management thinking? In all walks of life when things go badly wrong, people look to the leadership for accountability. If the leaders had their "hand on the tiller" surely it would not have been allowed to happen? Sometimes it is poor oversight and sometimes it is intentional.

This article explores how the leadership exerts a fundamental influence on the corporate culture of an organization, and how that influence sets the tone for the way the organization conducts business. It also explores the respective role of the Board, the Chief Executive Officer (CEO) and the Chief Compliance Officer (CCO). "Tone at the top" is becoming an increasingly used term in corporate governance to describe how the leadership culture pervades and cascades down the organization. Increasingly, when an organization is accused of some form of corporate wrongdoing, our gaze rests on the example set by the Board and senior management.

Setting the Right Tone

So what exactly do we mean by "Tone at the Top"? There are many ways to define it. It's a term that originated in the field of accounting and is used to describe an organization's general ethical climate, as established by its board of directors, audit committee, and senior management. It was originally construed fairly narrowly to the attitude of an organization's senior leadership towards internal financial controls. However, the term was popularized following a series of major accounting failures such as Enron, Arthur Andersen, and the U.S. Federal National Mortgage Association (FNMA), colloquially known as Fannie Mae, to name a few.

The definition has subsequently expanded to encompass a wider aspect of an organization's operations. It refers to an organization's guiding values and ethical climate, which are translated throughout the organization and designed to cascade and be observed at all levels. Corporate Governance commentators now tend to view it from the perspective of overall leadership conduct. It defines management's leadership and commitment towards openness, honesty, integrity, and ethical behavior.

Despite the expansion of its definition, it remains as one of the core principles of the Control Environment under the Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework (termed as Integrity and Ethical Values). How management and business leaders behave will set the tone for the way the employees behave. Is it a Code of Conduct? Arguably yes, but it is much wider than that. The former is a written statement of rules and expectations. Tone at the top is an unwritten value proposition that defines attitudes and values that business leaders are expected to support as role models. Leaders that fail to live the values they espouse will be quickly found out and lack credibility.

The Price of Reputation

Reputation risks are now considered as great as strategic, operating and financial risks, according to a recent survey conducted by Forbes Insights on behalf of Deloitte Touche Tohmatsu Limited. Accordingly, some companies will seek to enforce the tone at the top to protect their reputation. For example, when James Damore, a Google engineer, wrote a controversial memorandum following his attendance at a Google Diversity program, the company acted quickly to distance itself from his views. His suggestion was that men and women have psychological differences that originate from their underlying biology. Those differences make them differently suited to and interested in the work that is core to Google. The company responded decisively and rapidly, with Sundar Pichai, the CEO, terming the memorandum offensive and "not OK." Damore was quickly fired for lighting a firestorm that, if not handled in the right way, threatened to have a significantly adverse impact on Google's reputation as an inclusive employer that embraces diversity.

The Onset of Social Media and Implications for Business

The Google incident highlights the modern pitfalls for organizations in the social media age. Carefully nurtured reputations that have taken years to foster can be destroyed overnight by an incident or scandal that goes viral.

Through social media and mobile technologies the gaps between a leader's words and actions can go viral in a nanosecond. Once the damaging content is out there, the genie is out of the bottle. The future reputation of the organization is at stake, based on how it responds. The timing of the response is critical too. Wait too long and the more likely the response you give will be perceived as lacking in genuine intent.

For example, when a United Airlines passenger was dragged from an overbooked flight, sustaining facial injuries, the incident was filmed by a fellow passenger. That footage went viral and the resulting media firestorm threatened to engulf the company. Yet Oscar Munoz the CEO failed to respond for several days. When he did he accused the injured passenger of being disruptive and belligerent in resisting. Only when an online petition demanding his resignation reached thousands of signatures did he apologize for the incident. It was too little too late. Few treated his apology as genuine, and more as an attempt to protect his position. In the immediate aftermath, over $1 Billion value was wiped from the airline's stock price.

The Board's Role

The starting point for setting the tone begins with the organization's governing authority; generally, this means the board of directors. Boards are expected to appreciate that a healthy corporate culture is a valuable asset, a source of competitive advantage and vital to the creation and protection of long-term value. The preface to the UK Corporate Governance Code 2016 summarizes it succinctly:

One of the key roles for the board includes establishing the culture, values and ethics of the company. It is important the board sets the correct "tone at the top." The directors should lead by example and ensure that good standards of behavior permeate throughout all levels of the organization. This will help prevent misconduct, unethical practices and support the delivery of long-term success.

The board needs to play an active role in establishing the appropriate tone by cultivating a culture that gives high priority to ethical standards, principles of fair dealing, professionalism, integrity, full compliance with legal requirements and ethically sound strategic goals. These are noble aspirations, but how can the board achieve this:

- Firstly they must lead by example – that means working with the appropriate level of integrity and honesty; communicating their decisions in a transparent way that demonstrates that they are prepared to do the right thing; instill an atmosphere of collaboration by consulting with management and employees.

- The composition of the board is critical question. Does the board seek directors for their fit with the values of the organization? Does the board have sufficient expertise related to human resources and leadership development – important ingredients in shaping culture?

- Consider whether the board has sufficient training on ethics and compliance. It is an opportunity for the board to discuss how it encourages and oversees the ethical tone of the organization's culture. Often board training focuses on compliance and not on ethics and culture.

- Such matters as employee surveys can be useful tools to provide valuable insight into the state of the organization's culture.

- Compensation decisions made by the board send powerful signals throughout the organization's culture about what is valued.

- Failures and violations can be used effectively as learning opportunities. Developing clear disciplinary policies and following through on action sends a clear message about the company's commitment to maintaining standards. It also provides evidence of the effectiveness of the ethics and compliance program.

- Questions, questions, questions. The board needs to ask the hard questions to satisfy themselves that management has adopted the appropriate culture and is maintaining it. They can ask about the company's policies on whistle-blowing; management's response to allegations or investigations relating to suspected corporate wrongdoing; the company's interaction and relationship with regulators; policies relating to disclosure and transparency. The list goes on…

It is also important for the Board to be in touch with and understand employee morale and sentiment, including through updates from management, and in turn flow the corporate culture down through all levels of the organization. According to the Business Round-table Principles of Corporate Governance 2016, the "board should set a "tone at the top" that demonstrates the company's commitment to integrity and legal compliance. This tone lays the groundwork for a corporate culture that is communicated to personnel at all levels of the organization." (The Business Round-table is an association of chief executive officers of leading U.S. companies working to promote sound public policy and a thriving U.S. economy).

The CEO's Role

Corporate failures of the past invariably involve a CEO who is dogmatic in his approach. Consider Lee Iacocca, the charismatic former CEO of Chrysler Motors. His quest for personal greatness meant he spent more time on enhancing his public image and doing things that would please Wall Street than investing in new car designs or manufacturing improvements that would bring sustainable growth to Chrysler. In fact he set a tone that discouraged innovation, lobbying for the imposition of tariffs and quotas against Japanese imports rather than building better cars to compete against them.

The Enron saga is undoubtedly familiar to all of us. The culture that Kenneth Lay and later Jeffrey Skilling created laid the foundations for its demise. They looked down upon the talented people who had created the success story. They created an adversarial culture where brinkmanship and Machiavellian strategies were considered a sign of creativity and greatness. This pervasive greed led to the complex strategies that declared profit on ideas that were never implemented, and hid billions of dollars in debt, defrauding Wall Street and the investors, employees and pension holders. The monumental fraud was deeply rooted within the mindset of the leadership.

The influence of the CEO cannot be overstated. Internally, the CEO is the face of the organization and the figurehead to whom employees ultimately look for vision, guidance and leadership. Externally, establishing the right tone can serve to fortify the organization's reputation and its relationship with shareholders. The CEO needs to be a trusted figure within the organization. How can he achieve that? By connecting with people inside and out of the organization. It requires regular, transparent communication through the most effective channels, and for the CEO to consistently exhibit his core values and standards. This also means developing reward systems whereby behaviour that reflects the values are rewarded, and equally behaviour that conflicts with the values be disciplined. Clear rules and consistent enforcement will ensure that the values become deeply embedded within the organization. People will know the expectations and where they stand if they do not meet them.

The Chief Compliance Officer

Establishing the right tone at the top is much more than a compliance exercise, yet the CCO has a critical part to play in setting and reinforcing the tone at the top. The person selected for this role must be beyond reproach, someone whose integrity is clear and who can earn the respect of personnel at all levels, from the C-Suite to the factory or shop floor. In the world of globalization and increased competition, ever more complex international laws and standards, and onerous regulatory regimes, the issue of non-compliance is critical. The role of the CCO has never been more important. It is multi-faceted. Ensuring that business is conducted diligently, ethically and in compliance with accepted business practices is one aspect. Many perceive the role of the CCO as the key person to identify and manage legal and reputational risks. Critical elements of the CCO's mission is to raise awareness of risk; to develop training programs to address risks and to support the creation of the right culture; to act as an adviser to senior management and the board on the organization's commitment to ethics and compliance.

The CCO contributes to tone at the top both directly and indirectly. In framing elements like the code of conduct and mandatory training, the CCO has a built-in platform for reinforcing the organization's values. The CCO should also be the leader that employees can turn to for advice on ethical concerns. The CCO therefore is instrumental in creating a culture where employees can express their views without fear of adverse consequences, an essential element to creating a strong ethical tone.

The Business Case for the Right Tone at the Top

So how can the tone at the top influence and hopefully benefit the organization? What is the business case for adopting an ethical tone at the top? Maybe the question can be more usefully asked: What are the implications for an organization that does not adopt an ethical tone at the top? That's probably an easier question to answer; one only has to look at Enron, Parmalat, Nortel, Bre-X, Tyco, Fannie Mae, Worldcom (and so on) for the results. Below are some key benefits of adopting the right tone. These are not exhaustive.

- Stronger risk culture. An organization's culture can have a huge impact on its ability to prevent the occurrence of unacceptable risk events and identify new and emerging risks in a changing operating environment. It can highlight weakness in internal controls or organizational blind spots that may result in certain key risks being overlooked.

- Setting the right tone from the top is critical to building trust and value with shareholders, employees, customers and business partners. An organization that engenders trust and builds a reputation for ethical and fair treatment of all its stakeholders will enjoy a competitive advantage, attract shareholder investment and develop its client base. In a world of uncertainty, people want to deal with organizations they can trust.

- People are happiest and most productive working for companies whose values align with their own. The attraction of talent is a key priority for business leaders. In the social media world of today, many decisions are based on perceptions of an organization, and the recruitment process is becoming driven more and more by culture and reputation. Candidates want to find out what the culture is like, the opportunities for development and rewards, and the effectiveness of the leadership. Research shows that over half of job seekers would not take a role with a company that had a bad reputation, even if they were unemployed. Conversely a large majority would consider leaving their current job if they were offered another role by a business with an excellent reputation.

- There is a correlation between strong ethical values and improved financial performance. An ethical company can attract and retain a loyal workforce, is able to optimize its reputation, reduce its cost of equity, enhance supplier relations, and mitigate litigation and associated costs. It is a virtuous circle of "caring capitalism" whereby improved social performance leads to improved financial performance.

Case Study – Siemens

A fascinating case study in tone at the top is Siemens. The German engineering giant suffered a huge loss of trust following a bribery scandal in November 2006, when regulatory investigations revealed a systemic practice of corruption involving the payment of huge bribes to win contracts. However, the company did not hide. Its determination to face the truth put the firm on the path to recovery. Indeed, Siemens response to the scandal was widely applauded by many independent anti-corruption and ethics experts, including the Organization for Economic Co-operation and Development (OECD) and US Federal authorities.

The authorities uncovered widespread abuse that shamed Siemens, not only in the eyes of furious shareholders and investors but also the German public, and brought humiliation to its employees. The company came under intense scrutiny, its integrity was called into question, as were its senior leaders in allowing such practices to proliferate. Some institutional shareholders questioned the Board's oversight for failing to identify and eradicate such practices.

At first, Siemens played down the affair and key executives repeatedly denied awareness or involvement. This only served to raise questions in stakeholders minds about their competence as well as integrity. However, when Siemens' own estimates of the level of bribes spiralled to several hundred million dollars, Siemens announced its own rigorous internal inquiry by New York law firm Debevoise & Plimpton.

The new CEO Peter Löscher announced a month-long amnesty for employees to come forward, explicitly excluding former directors. Around 40 whistleblowers came forward with incriminating evidence. It uncovered systemic issues that contributed to the scandal, including: an aggressive growth strategy that, arguably, compelled managers to see bribes as a tempting short-cut to hitting tough performance targets; a complex, matrix-like structure that allowed divisions to effectively run themselves, and poor accounting processes. Indeed the corporate culture seemed openly tolerant of bribes, helping staff to feel they were "not only acceptable but implicitly encouraged".

The company acted swiftly and decisively to change its internal culture and to re-establish its reputation. It took the following actions:

- Appointed an advisor, Michael Hershman, co-founder of Transparency International and a leading anti-corruption expert.

- Rolled out strict new rules and anti-corruption/compliance processes and hired over 500 compliance officers and a former Interpol official to head its new investigation unit.

- Established compliance hot-lines and a web portal for employees to evaluate risk in their client and supplier interactions.

- Launched a comprehensive training and education program on anti-corruption practices for its employees. By 2008, Siemens had trained more than half its 400,000-strong global workforce on anti-corruption issues.

- Avoided competing in certain known hot-spots for corruption or unethical practice, such as Sudan;

- It agreed to a 15-year program to pay \$100m to non-profit organizations fighting corruption.

- The firm took over 900 internal disciplinary actions, including dismissals.
- The company restructured itself to a more streamlined model just three core divisions, industry, energy and healthcare, each headed by separate CEOs that sit on the Siemens Board.

Overall, the scandal cost Siemens €2.5bn, including €2bn of fines. The cost to employees was two years of humiliation shame under intense public scrutiny, especially in Germany. However the company has come out the other side commended for its approach and the new CEO has changed the corporate culture to one that is driven by high ethical standards. The company learned some valuable lessons along the way – unethical behaviour can be very costly; independent, ideally external, investigations are the most credible indicator of trustworthiness; the timescale for a cultural change is long – measured in years, not months; voluntary penance is often necessary for effectively restoring trust. It helps to demonstrate that the organization has learned from the experience and accepts its punishment.

How Can a Company Create and Maintain an Ethical Culture and Strong Tone at the Top?

To conclude, the following give a few pointers on how to develop and, more importantly, maintain the right ethical culture for your organization:

- It has to come from the very top. Consistent and visible executive sponsorship for ethics and compliance-related issues is mandatory to influence a change of culture;
- A culture change does not happen overnight. It needs patience. Understand what the prevailing culture is first, before attempting to make any wide-sweeping changes, and communicate the change message clearly to inform and drive the new culture before implementing change;
- Leaders are the agents of change, the role models. It has to be action based. Leaders must consistently 'do as they say', to behave and do business in a way that is aligned to and enforces the values and ethical standards of the business. Only that way can it cascade through each level of the business;
- Behaviour that is consistent with the values must be rewarded and recognized. Develop systems for doing so;
- Similarly behaviour out of alignment with the new value system must be acted upon and necessary action undertaken, openly and transparently. This may involve developing whistle-blowing procedures, but also sophisticated internal control systems that monitor and test compliance;
- Embedding systems and processes to support the Tone from the Top as 'business as usual' will help shape the organizational culture and measure the effectiveness of leadership actions and behaviours over a period of time

Adopting the right tone at the top is a business imperative. The cost of failure to do so in this highly regulated, social media world is crippling fines, lost business and a reputation destroyed overnight that will take years to win back. Just ask Siemens.

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Paul has almost 20 years of corporate secretarial, corporate governance and regulatory experience both in house and as a professional services consultant in the United Kingdom, Canada and the Caribbean. He has served in senior in-house roles for several financial services companies listed on the UK Stock Exchange and in Europe. He has also provided governance services to listed companies in Europe, North and South America and the Caribbean region. Paul has worked extensively with a diverse range of boards and senior management teams on governance matters, including the transition from a stakeholder to an independent board. In his previous role, he acted as Corporate Secretary and Governance Advisor to the Bank of Montreal's OSFI regulated subsidiaries. Paul has recently taken up a position as Head of Corporate Governance at the First Abu Dhabi Bank where he is responsible for the Bank's corporate governance framework domestically and across its international subsidiaries. Paul is a Fellow of the Institute of Chartered Secretaries and Administrators (ICSA) and holds a LLB from Middlesex University (UK). He is currently a speaker on the Governance Module ICSA Director Education and Accreditation Program (DEAP).