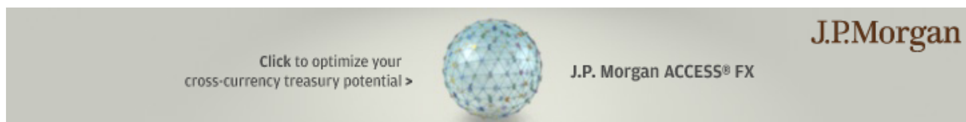

VIEWPOINT: Should boards and investors pay more attention to ethical culture?

18 Nov 2015 | Leo Martin

The emissions scandal at Volkswagen reveals just how costly a lapse in ethical judgment can be. VW shares have fallen by more than 40% since the scandal erupted in September. The company has lost its chief executive and suffered a massive third quarter loss of EUR1.67 billion.

Experts are predicting that the overall bill for legal costs, settlements with regulators, recalls and vehicle buybacks could reach EUR35 billion.

UBS analysts have described VW's corporate behaviour as "inexcusable" but senior management deny any knowledge of the emissions fixing devices. Matthias Muller has issued a statement saying that the Board of Management "deeply regrets this situation", while former CEO Martin Winterkorn denied that he was responsible for any wrong doing on his part and expressed shock that such misconduct could have happened at VW.

Not surprisingly perhaps, it has been argued that neither the firm's supervisory board nor its executive committee were doing their job properly. They are not the first and probably

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won't be the last to face such accusations, but what is the right approach? What can boards and investors do to ensure that such misconduct cannot go unchecked?

Ethical culture and business goals are at the heart of both the problem and the solution. If an organization is focused solely on growth and targets, then it runs the risk of creating perverse incentives that inadvertently promote bad behaviour.

This was apparent in the banking sector where aggressive sales targets linked to large bonuses led to miss-selling scandals and Libor fixing. So too with VW, Matthias Muller has admitted that too much had been subordinated to the desire to be "faster, higher, larger" in a bid to overtake Toyota by 2018. Instead, Muller has admitted, the company should have focused on qualitative growth with greater social responsibility.

Good corporate governance dictates that boards should look beyond the quarterly return and financial probity to ensure that corporate goals are balanced with the ability to ensure good corporate conduct. Investor groups such as Hermes want to see that ethical risks have been considered and that robust measures are in place to mitigate those risks and this should become more commonplace.

All too often boards are focused solely on issues of performance, while failing to take proper account of how an organization is managing and protecting its reputation. As we are increasingly seeing, this can do as much damage to the bottom line as poor corporate performance. Legislation against bribery, fraud and anti-competitive behaviour, for example, are becoming increasingly robust the world over, making prosecution increasingly likely. Assurances of ethical business behaviour therefore are important for the avoidance of highly damaging scandals that result from illegal activities.

Boards must engage with the way in which a company behaves and this should begin with the code of conduct. Does it include clear expectations of behaviour and are these expectations manifested by the senior management? Is the code shared with all relevant parties, including suppliers, subcontractors and joint venture partners? Is it properly embedded? Does it contain sanctions for misconduct and are these acted upon? Boards and investors need to engage with these questions to ensure that the organization's corporate

culture supports the necessary ethical decision-making and compliance that will provide the right answers and protect the business.

Internal or external auditing systems can and should be developed to enable an organization to monitor and measure the effectiveness of the code of conduct, with the results reviewed regularly by the board. This should include assessments of all salient risks and an analysis of the mitigation measures put in place to protect the organization. Any breaches of the code should be recorded and details of any remedial actions required fed back to the board. The key part of this type of audit is to move to a reputational audit system, which includes interviews with employees, contractors, suppliers, customers and other stakeholders to understand how policies and systems are working in reality - and crucially to understand if the company's reputation is being protected.

In addition to a detailed understanding of how the company is actually implementing its code of conduct, boards need to ensure that an effective reporting system is in place. VW has admitted that there was an authoritarian culture that positively discouraged dissent. Similarly, the Toshiba accounting scandal that came to light earlier this year showed how an overly consensual culture, fearful of challenging seniority, can have disastrous and costly consequences. Boards need to know how the company's reporting system works, that there is no fear of retaliation and that there is sufficient awareness of its existence throughout the organization. While measurement and benchmarking of reporting systems is still in its infancy, companies should nonetheless be monitoring the usage, follow up and the reasons for any calls, providing management reports that are regularly reviewed by the board.

Finally, board composition is vital to good governance. An effective board will have the right mix of skills, expertise, diversity and independence to enable it to provide proper oversight and guidance. Every board member should be able to contribute to overseeing the sustainable execution of the corporate strategy.

Investors need to play their part too, demanding reports for shareholders that show the necessary reporting of good governance practices. The future for businesses has to lie in long-term success and sustainable development. The role of the board should be to ensure that the correct strategy and

systems are in place to deliver that success, this cannot be done while asleep at the wheel, unaware of what is happening at the heart of their organizations.

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