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Whatever Happened to Values-based Corporate Governance?

by Pat Canavan and Thames Fulton

Corporate Governance Today

Over a decade ago, prior to the damaging impact of Enron, WorldCom, Adelphia, Parmalat and so many others, there was an active and constructive debate on values versus rules as the key driver in corporate governance. The International Corporate Governance Network (ICGN), discussions of the UK Cadbury Report and academic and regulatory debate in the U.S. all confidently raised arguments on both sides of the topic. This healthy debate ended in 2001. The ensuing public loss of confidence in directors and boardrooms, the increased empowerment of the SEC, and regulators in the UK and EU, plus the sweeping legislation of Sarbanes-Oxley and its local counterparts created and adopted in markets around the world showed that the debate was over: rules trumped values.

In the years immediately following the implementation of Sarbanes-Oxley, there was a limited re-emergence of interest in restoring a balanced discussion of behavior in the boardroom. The dialogue began around the belief that Sarbanes-Oxley was overly bureaucratic and too costly for mid-size and smaller firms. Recruiting competent directors became more difficult. Decisions made in the heat of the crisis were looked at as overreactions and expedient — the demise of Arthur Andersen, for example. Raising the bar to discuss management and the board's obligation to all constituencies — customers, suppliers, employees, communities and investors — was only just beginning.

But the prevailing questions remained: Who should serve as directors? How should such key topics as CEO succession, executive compensation, strategy, deals, and financial and operational performance be brought to and discussed at the board? Just how independent are directors in reality? How competent are audit committee members? How much control of the board agenda should be determined by management and how much by the board? How is power being distributed at the board level — is there a separate executive or non-executive chairman or a lead director? The underlying assumptions were twofold: (1) boards cannot be trusted and (2) boards need to be legislated and regulated into doing the right thing, and the right thing is exclusively watching out for investors/owners.

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Yet before the dialogue could change, along came 2008. And once more the public lost confidence in directors and boardrooms. Financial services organizations, mortgage companies, automotive manufacturers and others in the U.S. and abroad were caught out again.

In a shocking repeat of 2000 and 2001, again we witnessed lack of proper oversight, rubber stamping of management strategies and reports by ill-informed and unprepared directors, and the same improper trust by directors in management's honesty and openness in communication. The overall credibility of the corporate governance system had been shaken to the core. Cynicism of corporate governance flourished, and along came another round of severe measures. More boards were held up to public scrutiny, only to fail the test. Just as Max Weber had forecast over a century before in his analysis of bureaucracy, the system's response to failure in compliance is to create more rules demanding more compliance.

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And that is where we find ourselves in 2012. "It's easy for directors to feel trapped in the rules paradigm. We have overshot the mark. It's time for boards to think about principles and do the right thing, but it's challenging to do this given the current punitive environment we are in." Says M. Shân Atkins, experienced director.

Getting Directors on Boards

Recruiting directors has become even more difficult over the past decade. The need to comply with listing requirements for independent directors has led to a bias toward ultra-independence. Although this looks good on governance scorecards, one unintended consequence is that industry and market knowledge often are missing in the director candidate's background. Is strict compliance truly of value to the discussions and decisions at the board? Or is it another example of rules trumping values?

The increased time requirements for committee work and board meetings have resulted in a heightened need for relevancy in director interactions with one another and with management. Getting to the critical few issues, the causal elements of corporate results through on-point questions directed at the right person is what brings insight to the board. Coupled with these insights is a need to have the experience and communications capability to give sound advice and counsel, provide oversight and make decisions only on those issues chartered for the board. Where does this insight and experience come from? Reason suggests that good targets would be CEOs, COOs and CFOs of companies in related industries.

Again, this does not look good on governance scorecards but may be the best way to add value to shareholders, customers, suppliers, employees and communities. According to Atkins, "Board composition is important when considering how to foster a values-based dialogue amongst directors. Today, we are seeing a trend toward recruiting directors with a specific functional expertise, which is helpful when you need deep insight into one area, but too much of this can limit the extent and scope of the dialogue. We are also seeing fewer and fewer directors with relevant industry and general management experience."

The emphasis on compliance and regulation de-emphasizes the basic building block of good business and good relationships: trust. Directors need to have trusted relationships with management that assume that necessary information — good and bad — is communicated in a timely and forthright manner. Directors need to be part of the governance and performance processes and as such need to be informed by management and loyal to shareholders. This does not translate into being disloyal to management.

Directors who have the maturity and character to both engage deeply with management and confront areas of ambiguity or disagreement with directness and perseverance are what provide long-term value. It is not about checking boxes, reading the reports and logging the hours. It's about becoming an effective team — enacting defined roles, unabashedly exercising power as chartered — and understanding that the corporation cannot succeed without the commitment, intelligence and energies of management, nor can it sustain itself without a proactive, engaged board.

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Values-based Governance Versus Rules-Based Governance

Simply put, values-based corporate governance has been referred to as the "institutionalization of ethics" into the conduct of the board and management. The belief is that the overwhelming majority of people behave in ethical ways, prefer the moral high ground, and understand the short- and long-term benefits of doing the right thing by customers, suppliers, employees, communities and shareholders. The rules are still there, of course, but they are broadly written, serving to show where mismanagement, malfeasance and criminal behavior are present and also indicating the extent of negative consequences for behaving badly.

Rules-based corporate governance starts with an entirely different assumption. It assumes temptation and the desire for personal gain is rife in corporate life; therefore monitoring, reporting, strict guidelines and detailed restrictions on behavior are the avenue to achieving ethical and right behavior from management and boards. Clearly the cycles of dishonest, improper and criminal behavior in some companies over the past decade followed by increased legislation and regulation have squarely placed us in a rules-based environment. Yet rules on their own are not enough. They cannot easily adapt or allow for nuance and so, because of this, a rules-based system of governance alone is incapable of addressing the complexity and mutability of the global economy.

Implementing Values-Based Corporate Governance

The dialogue in corporate governance circles has evolved only slightly in the past few years. For one, the discoveries following the financial and mortgage meltdown of 2008-2009 demonstrated that no amount of legislation and reporting can deter management from behaving improperly, boards from being ill-informed and shareholders from suffering at the mercy of those agents of the corporation. Is the answer to once again pass more laws and draft more regulations? Or is it time to simplify the conversation and to remind directors and management of their roles and responsibilities in clear, simple terms that speak to doing the right thing — beyond merely doing what is required?

At its most basic, boardroom discussions and decisions in the C-Suite have to answer to a human metric: Would you be proud to explain what you just did to your children tonight over dinner? Would you want to read this conversation or meeting described in the Wall Street Journal tomorrow? Against these metrics most people know what to do.

The role of the board is to ensure that the proper people with the proper value systems are in place and that the corporation has an ethical environment worthy of its shareholders' trust. Boards do this through their selection and ongoing commitment to the CEO, to their criteria applied in succession and leadership reviews, and in their communications and interactions with Management. Boards must constantly and unequivocally express these expectations and show intolerance for any breach. Directors therefore need to be selected for more than expertise and acumen. In addition to high character, directors need honesty, courage and integrity to be effective. The governance and nominating committee has the responsibility to populate the board with such people – people capable of implementing a system of values-based governance.

According to Alan Bennett, experienced director, "Rules on their own do not solve anything. You have to have the very best framework in place to react to and adequately address a situation. Things will go wrong, but if you have an infrastructure that's been built appropriately and people who understand and believe in the tone and values being communicated, then your process will allow you to course correct. You run the process and wherever it leads, you will be doing the right thing."

Moving Forward

The past decade has been tough on the reputations of many companies, their boards and their management. Too often the business and the popular press portray CEOs and C-Suite incumbents as overpaid, unaccountable, controlling schemers who are indifferent to shareholders, and who have their boards "in their pockets." In reality, being a company director is an incredible responsibility, demanding of time and taxing of capabilities.

People who agree to be recruited as directors know that they are taking a reputational risk in joining a board. They are dependent on the competency, honesty and communication abilities of their fellow directors and of management. Doing the job well — and discharging the chartered responsibilities of the board — requires exemplary commercial and interpersonal skills. To effectively serve on committees and the board, to provide sound advice and counsel to management, to contribute to the decision process as an informed and loyal director requires far more than knowing the rules and signing the forms. It requires a high degree of ethics, an intent scrutiny of the behaviors of the key agents in management and on the board, and the courage to raise questions and issues when any doubt is present. Attention to these aspects lies at the heart of value-based corporate governance. We need to advance this agenda, to focus on the institutionalization of ethics and the selection and development processes for character-based leadership on boards and in management. "The fact of the matter is, a values-based approach is just good business. It takes 100 years to create a solid reputation and 5 minutes to ruin it," says Bennett.

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The recently released 2012 Edelman Trust Barometer reinforces the line of reasoning advanced here. In Edelman's 12th annual global trust and credibility survey, findings indicate that the state of trust, particularly in business, is in "a high state of disarray" and that "rank-and-file employees now have more credibility than chief executives."

To restore trust, the survey proposes that business must "exercise principles-based leadership instead of rules-based strategy. Business should not go to the edge of what is legally permissible but rather stay focused on what is beneficial both to shareholders and society."

Although the survey's terms may differ, the point is precisely the same as expressed throughout this article.

Clearly the time has come to move forward, not only by doing what is required but also by renewing the focus on doing what is right. The path to better governance – and restoring trust in the system – begins with competent, trustworthy leaders who embody good values, serving within organizations that encourage them to exercise those values.

About the Authors

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