

# When compliance is not enough

In the first of three articles, John Plender and Avinash Persaud describe the challenges facing managers in creating an ethical culture

The extraordinary expansion of company legislation and corporate governance codes across the world since the collapse of Enron, the energy trader, has had many unintended consequences. One of the more paradoxical is the damage that has been done to business ethics.

The attempt to legislate and regulate people into good behaviour has spawned a compliance culture rather than an ethical culture. Too many boards have outsourced the task of ethics to ethics officers, who have turned to consultants to define the company's values. Ethics have become something that "other people" in the organisation worry about, leaving everyone else unfettered by such concerns. Does it matter? And if it does, what can be done about it?

We will argue in this and subsequent extracts from a new book\* that ethics do matter in business because they underpin trust, which is fundamental to business relations. Markets work more efficiently where there is trust between participants. Within the company an ethical culture provides the glue that makes for a cohesive and effective organisation.

It is, of course, possible to run an organisation efficiently without trust and without integrity. Colombian drug syndicates do this. But it requires punitive management and control. Where there is a deficiency of ethical values in more conventional business it is similarly necessary to fall back on punitive laws and regulations, although of a less violent kind, such as the US Sarbanes-Oxley Act.

In short, a lack of trust leads to higher compliance costs as more business behaviour is subject to increased legislation and litigation. Moreover, there is a growing economic literature pointing to a relationship between the level of trust in an economy and the development of financial systems and large-scale businesses. Low-trust economies such as China, rely heavily on the

family business model and find it hard to build big private sector companies.

What this means in practical business terms has been well expressed by Marvin Bower, who built McKinsey into the world's most admired consultancy (see below). Yet the most compelling case for business ethics is simply what happens without them. The cost of ethical shortfalls at Enron, WorldCom, Parmalat and others is there for all to see.

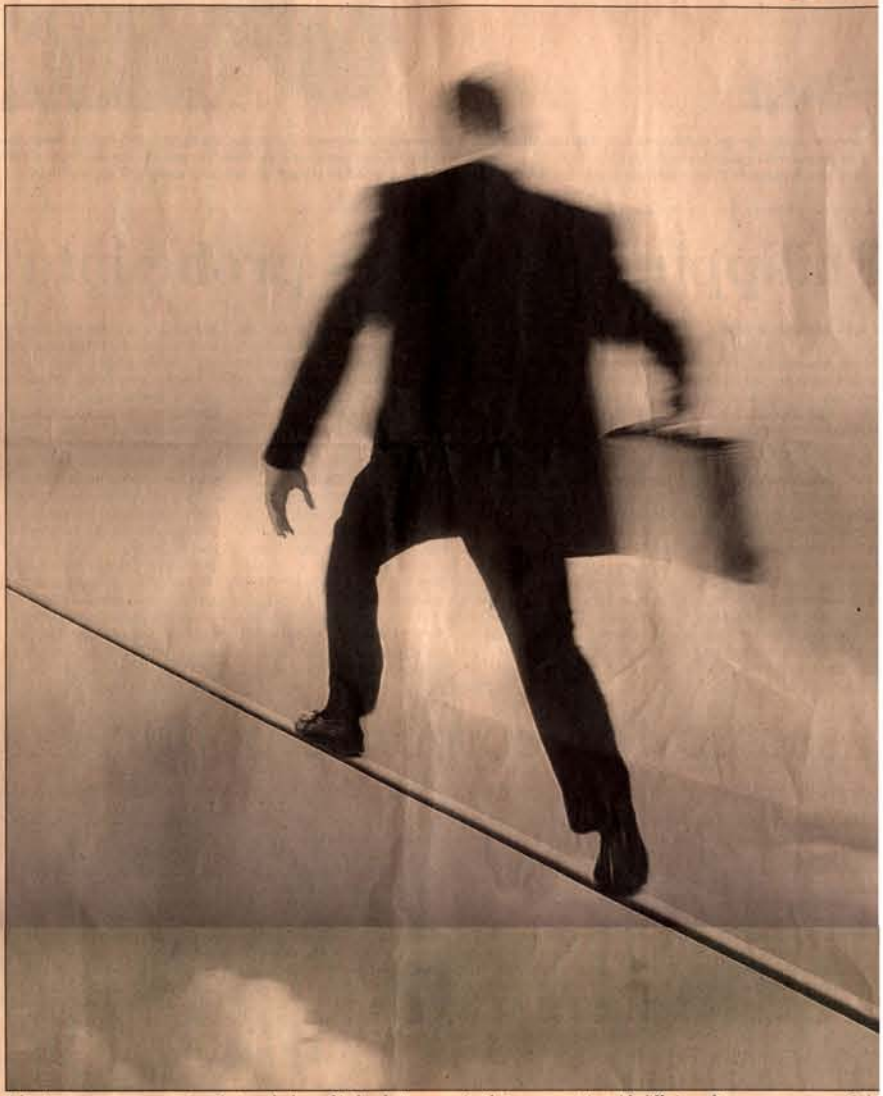
The problem for boards and managers is thus to find practical ways of establishing an ethical culture and pre-empting potentially damaging unethical behaviour. This is especially difficult for organisations whose opera-

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tions span many countries and cultures. A case in point is the US financial giant Citigroup, where a rigorous attempt to embed an ethical culture ran into difficulty on the trading floor in London (which will be explored tomorrow) and in Japan.

In our view an ethical culture must start not with a code but with individual responsibility. This does not imply a dysfunctional organisation in which employees pick and choose what they wish to do on the basis of their personal ethics. It means an organisation open to questioning and amending its behaviour in response to the ethical considerations of its employees, managers and shareholders and, in appropriate measure, its clients, business partners and the community.

Achieving this is substantially a matter of leadership. An ethical culture has to be embedded, which is a considerable management challenge. Codes are part of this



Balancing act: managers can struggle to embed an ethical code in companies that span countries with differing cultures

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process. In writing codes of ethics it is vital for managers to engage employees throughout the company. A code promulgated from the top, without consultation, will command little support among employees. Excessive reliance on outside consultants will all too easily lead to a bland ethical template that fails to embody the best internal standards, tradi-

tions and values. Internal input is helpful to the embedding process.

Leadership also means setting an example. This is more about openness, responsiveness and courage than being saintly or always beyond reproach. It is particularly about taking ownership of decisions and actions. There are many things managers should delegate to others but ethical responsibility is not one of them.

Apart from the notion that ethics are "other people's" problem, the biggest obstacle to establishing an ethical culture is short-term incentive structures. Most recent ethical abuses in the English-speaking countries have been about cooking the books in order to boost senior managers' pay. This has taken many forms, from shuffling costs and revenues from one reporting period to another, to adjusting retrospectively the strike price of stock options. It is pervasive. Jack Welch, former chief executive of General Electric, has admitted that his executives at GE were willing to engage in earnings management, albeit perfectly legally. Royal Dutch Shell, once regarded as a beacon of ethical solidity, fiddled its

production reserve figures. Even such innovative technology giants as Apple have been caught up in the options backdating saga.

Such ploys, whether legal or illegal, have occurred in a world where a high proportion of boardroom pay consists of equity and stock options. Increasingly, pay is performance related, with performance being geared to the share price – a variable governed by many factors unrelated to the individual company's performance – or to earnings, which are easily manipulated. Add the pressure on executives from fund managers and analysts to "make the numbers" and you have a recipe for ethical lapses.

These incentive structures in the boardroom and below are subverting efforts to instil ethical behaviour, as well as being commercially disadvantageous. Part of the task of business leaders in

the Anglo-American world is therefore to redesign reward systems to ensure they do not undermine ethical behaviour. That means fewer stock options and more plain, if restricted, equity and less reliance on share price or earnings-related performance measures.

The task of helping people find a moral compass in the complex world of business is a challenging one. But the benefits are real.

Tomorrow: Citigroup's drive to instil an ethical culture

All You Need To Know About Ethics and Finance by John Plender and Avinash Persaud will be published in September by Longtail Publishing, [www.allyouneedtoknowguides.com](http://www.allyouneedtoknowguides.com)

The authors will answer readers' questions on business ethics at 1-2pm BST on August 24. Go to [www.ft.com/ethicsqa](http://www.ft.com/ethicsqa)

## Founder of McKinsey's values

Companies that place emphasis on an ethical culture often owe this commitment to the vision of a forceful founder. That is true of McKinsey, the consultancy led for many years by the late Marvin Bower, who believed it was the job of a leader to shape a set of common values that would help an organisation grow.

Executives in well-run companies, he observed, often referred to "our philosophy" or "the way we do things round here". Such a philosophy evolves as a set of guidelines or rules that gradually become established, through trial

and error or through leadership, as expected patterns of behaviour.

McKinsey's stated values today still substantially reflect Bower's philosophy. High ethical standards, he argued, contributed to three main competitive advantages:

■ A business of high principle generates greater drive and effectiveness because people know they can do the right thing decisively and with confidence. They know that any action that is even slightly unprincipled will be generally condemned.

■ It attracts high-calibre people, thereby gaining a

basic competitive edge.

■ It develops better and more profitable relations with customers, competitors and the public because it can be counted on to do the right thing at all times.

Under Bower integrity at McKinsey was paramount. "If you are not willing to take the pain to live by your principles," he once remarked, "there is no point in having principles." When one of McKinsey's most talented and prolific generators of fees became involved in a serious conflict of interest that violated the firm's values, Bower gave him 30 minutes to clear out.

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