Corporate Credibility – A Wake up Call!

by Geoff Nunn FAHRI, GAICD

Abstract

In this article Board and Governance Advisor, Geoff Nunn, takes a critical look at current crisis of confidence in our corporations and government institutions in Australia. The 2018 International Edelman Barometer ranked Australia the 8th lowest of 28 countries surveyed when it came to the general population's trust in our institutions. This will come as no great surprise to many readers as recent inquiries have uncovered a litany of transgressions which have seriously undermined public confidence.

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Background

Every day we hear about another failure of corporate social responsibility. The provision of poor quality financial planning advice, market manipulation by our major financial institutions, tampering with vehicle emissions software and underpayment of employees by franchise stores are just some examples. The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry uncovered a 'fee for no service' charge to customers, interference with external legal advice and misleading reporting to the regulator by the AMP.[1] At one Commonwealth Bank branch staff are alleged to have meddled with school kids savings accounts to meet performance targets and qualify for incentive payments. The list goes on.

These transgressions represent the tip of the iceberg as various inquiries and regulators probe into what has become an all pervasive norm in corporate culture: the relentless pursuit of sales and profit without due regard for the impact on various stakeholder groups. A culture where the standard of business ethics in Australia appears to have sunk to an all-time low. At least that's the public perception.

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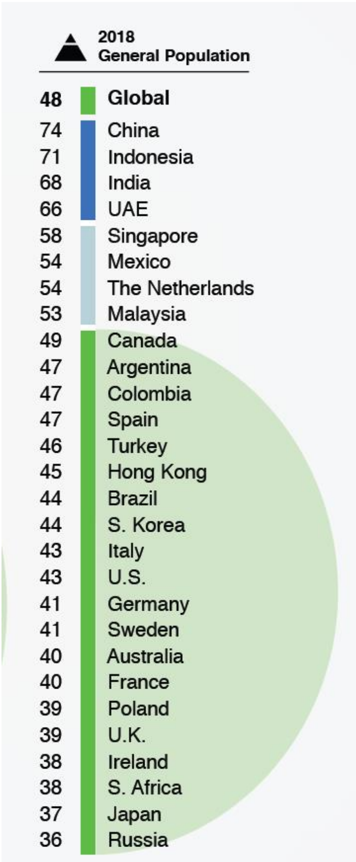
[1] See ABC 4 Corners 23.7.2018, http://www.abc.net.au/4corners/money-for-nothing/10026944

The boards and executive teams of some of our major corporates are in damage control. Public trust has been seriously eroded. Heads are rolling and some may face the prospect of criminal proceedings. A few directors are squirming in the board room chairs.

<u>How Has This Situation Come About?</u>

The Edelman Trust Barometer 2018 shows Australia now ranks below many of its peers—most of which are not looking too good either. A significant proportion of the population distrust our institutions.



2018 Edelman Trust Barometer, P6

We rank slightly higher when an "informed public" is surveyed being closer to the middle of the range of countries. In a recent report by the AICD and KPMG <u>Maintaining the Social Licence to Operate</u> 2018 Richard Boele is quoted:

> "Vulnerable stakeholders are the ones we have difficultly hearing because their voices are filtered out by layers of management that are using a business only lens to prioritise their biggest risks"

There is a growing sense across the community. Many believe our institutions are failing us. They are not living up to expectations when it comes to ethics, honesty and integrity. The Banking Industry Royal Commission has confirmed what many of us already knew: the pursuit of shareholder returns is being prioritised above the interests of other stakeholder groups, particularly customers.

Boards and Directors

Under the Spotlight

The AICD Report identified the three key stakeholder groups in which an organisation needs to maintain trust:

- Customers or clients;
- Employees
- The local or regional community

Unfortunately some of the Banks and other financial institutions are not looking too good in respect to these stakeholders.

Why Have we Lost Trust In our Institutions?

It's difficult to say exactly when and how we began to lose trust in our institutions. It's happened progressively over the last 20 years. Some of the contributing factors might be:

1. Various inquiries into institutional conduct in recent years have found that a number breached the trust of those that they were meant to serve. Some failures have shocked the community. This includes failures by the banks, corporates, churches, government institutions and even NGOs. These breaches have called into question some organisations' social license to operate. Many believe that some directors, CEOs and other leaders have lost their moral compass and have either engaged in or sanctioned inappropriate behaviour by their organisations.

2. The pursuit of profit and shareholder returns has become the dominant mantra for our listed and private corporations. It's a competitive landscape and shareholders are demanding. Particularly institutional shareholders. Consider this quote from ACCC Chair, Rod Sims:

   "Many companies set high profit growth targets to meet market expectations. ……..Some appear to ignore the risk of reputational damage over the longer term to achieve short-term gains."

   Companies Behaving Badly, Rod Sims, 2018 Giblin Lecture, 13.7.2018

   But profit by pushing products that the customer does not want, do not fit well or cannot afford is unethical at best. Charging for services not delivered is downright dishonest.

3. The GFC left a bad taste for many. It was seen to be driven by corporate greed. Many individuals lost large sums of money, including for some, their retirement savings. Sub-prime lending practices in the US were predatory. The commodification of low quality mortgages, to be sold as parcels of debt, was seen by many analysts as the creation of just another high risk financial product. With the exception of Lehman Brothers the companies and individuals largely responsible were bailed out by various governments and continued to enjoy considerable power, wealth and influence.

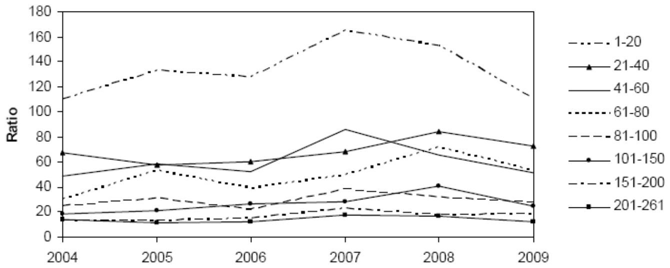
4. The outsourcing and off-shoring of call centres and customer service in a number of our industries does not sit well with many people. Competitive pressures are such that companies seek savings where they can and the use of call centres in India or the Philippines is an attractive measure. Not only have we lost many lower skilled jobs in Australia but many feel that the quality of service they receive is substandard.

5. CEOs are the public face of our corporations. Some come across as self-serving, arrogant and egotistical. A healthy ego is a pre-requisite for a CEO. But recent cases where arrogance has spilled over into psychopathological behaviour is of great concern.

   "A psychopathic diagnosis requires a lot of boxes to be ticked, such as ruthlessness, narcissism, persuasiveness, the inability to feel guilt, or the inability to see things from another person's perspective." *Lindsay Dodgson, Business Insider, July, 2017*

6. Remuneration differentials have widened. Over the past 20 years the gap between pay for the lowest paid employee and the CEO has grown progressively to the point where CEO remuneration in some of our larger listed companies is well over 100 times average weekly earnings. The following graph illustrates:

Figure 3.5 **Ratio of CEO remuneration to AWE varies by company size, 2003-04 to 2008-09[a, b]**



Executive Remuneration in Australia. <u>Productivity Commission</u> Dec. 2009

The level of growth appears to have tapered off. But many argue differentials remain too great. Remuneration advisors and directors will assert that this phenomena is market driven as competitive pressures force boards to seek out the best executive talent, locally and internationally, which comes at a price. This is no doubt true in some cases but represents only part of the story. Pitching high in the market creates inflationary pressures and benchmarking against like companies can have a ratchet effect.

7. Board visibility is an issue. In some of our corporations the board is perceived as a shadowy group.

> "Not much is known of what boards do from month to month, and in most organisations you would be hard pressed if you asked a staff member who was on the board to get a response beyond <u>one or maybe two people (and usually only the name of the Chair)."</u>
>
> *<u>The Faceless Board—Reconnecting to Your NFP Community.</u>*
> *Better Boards David Bartlett August 2012*

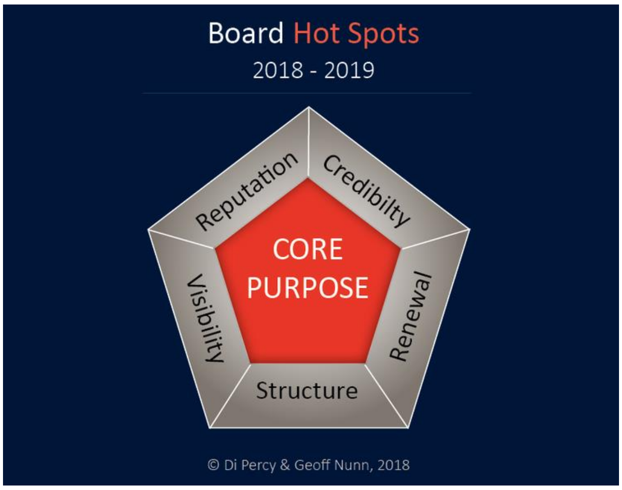
8. Governments at all levels and of all persuasions have frequently appeared paralysed when it comes to significant policy decisions. Renewable energy is a typical example where Australia had a unique opportunity to lead the world ten years ago. But successive governments

prevaricated, pandered to different interests and ended up with a policy hotch-potch which deterred some international investors. Short term political interests are seen to detract from sound long term strategy. And political back-biting is so entrenched in Australia's political landscape that even new entrants eventually succumb to groupthink and start bagging the opposition.

Where To From Here?

Some boards face a major challenge. How to re-build their organisation's credibility? So that when a member of the public, other organisations and governments hear a company's name they regard it with respect. Not suspicion. A company's whose profile is marked by a high standard of business integrity. The Board and CEO are present in the communities they serve and are regarded as good corporate citizens. Wishful thinking in today's competitive global world? We still have companies and government entities like this: respected brands and names. But the Edelman barometer tells us it's not the norm it should be.

We've seen some of the reasons about how we got here. So let's have some ideas about how to reclaim trust. The starting point is to think about these five critical governance issues:



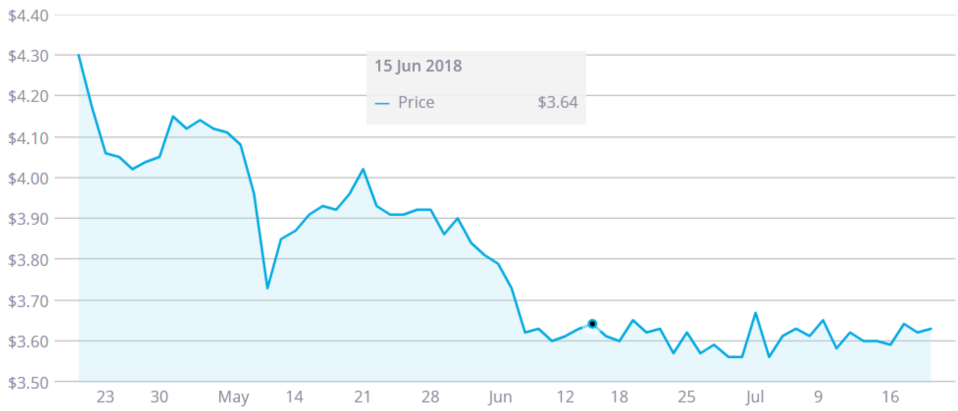
Everything is linked. Nothing stands alone.

1. **Core Purpose:** you may think your organisation exists primarily to make money for the owners or deliver an essential service. That's only part of the story. It is likely that it fulfils a social function; like making fresh pasta, providing legal services to help us navigate today's complex legislative environment, or provides water and wastewater services.

Some organisations have taken the step of articulating their "Core Purpose" and publicly stated why they exist and how they are going to be present in the communities they are part of. This goes beyond vision, mission and values. If faces outward directly into the organisation's constituent base. It often forms part of a "Statement of Corporate Intent".

2. **Reputation: i**ssues emerging from the Banking Industry Royal Commission highlight the very real risks to an organisation's reputation if its conduct dips below good governance standards and community expectations. Reputation is a fragile asset. Some commentators assert that up to 25% of a company's market value is tied up in its reputation.

   In today's world of social media, incidents that might previously have gone unnoticed very quickly spread throughout the world. Just think of the damage a rogue trader or shonky financial planner can do to a financial institution's reputation. Consider the AMP's share price graph in the light of recent revelations about fee for no-service charges to clients, interference with independent legal advice and misleading the regulator:



Source: AMP Website 23.7.2018

   But reputation risk is not just about the risk to financial viability. It's linked to Core Purpose and being a trusted participant in the community.

3. **Credibility:** credibility is linked to core purpose and reputation. When an organisation acts in ways that are perceived as deceitful or dishonest by its stakeholders it very quickly loses credibility. It takes a long time to build a credible organisational profile. But it only takes one incident to undo years of good work.

4. **Renewal:** board renewal is not just about finding new directors. If any of us stay in the one job for too long we become stale. This holds true for directors as well as employees. Besides succession, as individuals we need fresh challenges to revitalise the spirit. We need to continue to learn and develop.

   Like all human groups, behaviour in the boardroom is shaped by a range of conscious and unconscious process. What gets said at board meetings is only the tip of the iceberg. There's a lot more going on beneath the surface.

   Sometime we need to be brave and peel back the cover to see what's really going on. This is confronting. Board dynamics can be positive and enhance functioning. But they can also be negative and inhibit sound decision making.

5. **Visibility:** to most customers, employees, suppliers and other stakeholders directors can be shadowy figures in the background. Unless you're an informed shareholder you are unlikely to take much interest in the board of the company you've invested in. Even then you might only read about the board in the annual report. Or if you're an active shareholder you might go to the AGM and see a row of faces lined up behind tables each with a nameplate. Probably only the Chair, the CEO and CFO will speak at the AGM. Yet all directors have a significant role to play and being visible builds trust and understanding.

   Being a company director is not a passive role. All directors need to be present in the organisations they govern and the communities in which their organisation operates. Not in a way that undermines the CEO and Executive Team. But in a way that re-enforces a valid good governance presence.

6. **Structure**

   The foundations of effective board functioning (structure) are not always applied with agility and awareness. Company and industry changes may call for structural review and development resulting in innovation and adaptation. That is, structures also need adaptation and fresh eyes in times of change.

Concluding Comments

The Banking Industry Royal Commission, the ACCC's Retail Electricity Pricing Inquiry and various other investigations into corporate conduct have provided Boards of all descriptions with a unique opportunity. It's a wake-up call. An opportunity to do some deep soul searching around core purpose , business ethos and attend to building community trust in their organisations. Focusing on the five key governance issues outlined above is a good starting point.

About the Author: Geoff Nunn manages an independent governance and board advisory practice. He has lodged a Submission to Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry in Australia arguing for a return to a more balanced approach to executive remuneration.