



A view from the top

Business ethics and leadership

ADVISORY



Foreword

Our latest international survey of triple bottom line reporting, the KPMG *International Survey of Corporate Responsibility Reporting 2005*, demonstrates how business leaders have come a long way in responding to changing societal expectations by developing organisational infrastructures to manage and report on their social and environmental impacts.

Boards usually accept that business ethics is a 'tone at the top' issue. However, many boards appear to be uncomfortable about formalising the ethical dimension and remain reticent in developing tracking and reporting systems to ensure ethical accountabilities.

Yet ethical business conduct - or the lack of it - is a key factor in the long-term viability and success of all of our enterprises. Moreover, the reputations of individual directors and executives are tarnished when a business is seen to have acted unethically or otherwise breached community standards. My global role as KPMG's global partner in charge of People, Performance and Culture signals our boards commitment to managing our culture as a vital corporate asset.

Of course, it is not easy to define what constitutes ethical or unethical behaviour in any particular set of circumstances. The ethical goal posts are constantly shifting. Boards are unsure of how they should deal with this uncertainty.

This white paper examines these issues through the insights of selected Australian directors supported by contemporary Australian and international research. While these views do not necessarily represent the opinion of KPMG, we hope this research will assist boards to take a practical and more active role in shaping the ethical dimension of their organisations and spread the net of board stewardship to include robust ethical infrastructures. This will complement the advances already being achieved in the social and environmental accountability areas.



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Executive summary

In 2000 KPMG conducted research into Australian boards' perceptions of the ethical dimensions of business life. In 2005 a new research project sought to update the earlier findings and provide new insights into board perceptions and management of business ethics. Our latest research delivered several key findings.

- Ethical debate is not a regular feature of most boardroom agendas. Australian directors continue to approach ethical issues in an informal and personalised way.
- A lack of role clarity and accountability for ethics between the board and CEO inhibits the entrenchment of ethical standards.
- Few Australian companies appear to possess an explicit reporting framework to underpin their ethical commitments.
- Boards are most likely to reflect on ethical issues following adverse media exposure, episodes of high staff turnover and remuneration reviews.
- Boards are generally aware of the public's lack of confidence in business, but believe this largely reflects the news media's propensity for sensationalism and its lack of understanding of business issues.
- Only a minority of boards have undergone any formal training in managing ethical and other 'cultural' issues.
- Australian business suffers a vacuum in the advocacy and stewardship of business ethics.

In general, the increasing demand for board attention to compliance and a procedures-based approach to risk management can hinder a board's visibility of ethically inappropriate corporate practices and decision-making.

Business ethics

The Macquarie Dictionary defines ethics as “...a system of moral principles by which human actions and proposals may be judged good or bad or right or wrong”.

In a business context, ethics (or the lack of them) influence corporate behaviour. In the popular mind, business ethics are inextricably linked to notions of honesty, integrity, trust, accountability, transparency and social responsibility.

Research suggests major Australian corporations are failing to meet community expectations in matters of ethical conduct. For example, the 2005 Sweeney Research *Eye on Australia* report found that nearly two thirds of Australians perceive business leaders as untrustworthy. More than half believe that big corporations have no morals and ethics. Other research has consistently reaffirmed these findings.

Creating an “appropriate culture”

In short, Australians are saying business has ethical and social dimensions that transcend mere commercial considerations. Ultimately, business ethical standards are set by society, not business.

At the same time, the legal and regulatory environment in which business operates has become more demanding. The introduction of the Criminal Code (2000) explicitly held company directors responsible for creating an ‘appropriate culture’ within their respective organisations. It gave statutory recognition to the role that directors play in shaping the social context in which business gets done. A raft of other legislative and regulatory changes has sought to improve standards of business conduct in Australia.

Has all of this actually improved the ethical climate of Australian business?

Well, it has almost certainly led to an increased corporate sensitivity to legal and regulatory compliance. It has seen an increase in references to ethical behaviour in company mission statements and the like, and in the introduction of formal codes of conduct. It is less clear that companies are actually weaving ethical considerations into the day-to-day conduct of their businesses. Contemporary research has found that while around three quarters of major Australian companies believe it is the responsibility of their boards to set an appropriate ‘tone from the top’ and monitor organisational performance against a formal code of conduct, 84 percent of companies that had promulgated a code of ethics reported that they did not actually monitor compliance with it!¹

¹ Centre for Research into Ethics and Decision Making in Organisations, *A Survey of Ethical and Value Practices of the Top 200 ASX Listed Companies*. 2005.

Public symbols

Certainly many organisations participate in “reputation indexes” in order to promote their approach to corporate social responsibility. These external measures have flourished in recent times. However, is it possible to dissect and assess the ethical dimension of corporate culture in the manner these questionnaire-based approaches suggest?

The reality would seem to be that there is an opportunity for Australian boards, CEOs and other senior managers to become more comfortable with taking a proactive approach to ethical issues and actively participate and contribute to enhancing the ethics debate.

Is this a peculiarly Australian response to the issue?

An international perspective

At the World Economic Forum in January 2005, leaders from business, academia and government agreed the six top priorities on the global agenda to be poverty, equitable globalisation, climate change, education, Middle East instability and global governance. They identified integrity, compassion, equity, tolerance, selflessness and stewardship as the key guiding values in addressing pressing world issues.²

The intent and spirit are no doubt sincerely meant. However, international research indicates that while corporate leaders are increasingly thinking about what ethical behaviour might mean in a global setting, actions at a local level are proving more challenging to put into practice.

National and regional differences

In fact, there are distinct national and regional differences in corporate responses to ethical issues. For example, a 2004 international survey³ found that only 39 percent of the boards surveyed actually underwent formal training in ethics and compliance matters, although 77 percent felt such training was necessary. In Japan, 94 percent of respondents felt ethics training was necessary, in Western Europe only 42 percent of respondents endorsed such training. In the United States and Japan, ethical concerns appear to be substantially driven by regulatory compliance, whereas in the United Kingdom and India the enhancement of corporate reputations seems to be the key motivator.

In the United States, for instance, the recently revised Federal Sentencing Guidelines provide for reduced criminal sentences for errant directors and executives if their organisations have institutionalised measures to encourage an ethical corporate culture. Explicit in this measure is the requirement for boards to be directly involved in establishing and overseeing ethics programs and training.

Research elsewhere in the United States⁴ has contrasted the boards of high profile corporate failures with boards considered best in their field. Top boards demonstrated healthy cultures in which trust and openness between directors and between boards and management flourished. Here was a willingness to share information, questions and discussions were encouraged and there were regular reviews of both board and individual performance. These findings point to the silent but critical role boardroom culture plays in shaping broader organisational culture, and whether policies and procedures move beyond intent to become embedded in the day-to-day practices of the organisation.

Setting an appropriate ethical 'tone from the top' is further complicated by confusion over who is ultimately responsible for maintaining ethical standards. In the United Kingdom, the *Corporate Use of Codes of Ethics: 2004 survey*⁵ reviewed business ethics practices in FTSE 100 companies. It found that while 91 percent of these companies had a code of business ethics, only 26 percent of boards or CEOs regarded themselves directly responsible for ensuring ethical behaviour in their organisations. Although this number has increased (up from 12 percent in 1998), it is notable that almost three quarters of these leading British companies appear to assign ethical accountabilities elsewhere.

² World Economic Forum, *Global Town Hall Report*, January 2005.

³ Berenheim & Kaplan, *Ethics Programs and the Role of the Board*, Conference Board research report 2004.

⁴ Axelrod, Nancy, *In the Boardroom, Culture Counts* Journal of Association Leadership, Fall 2004.

⁵ Webley, Simon & Le Jeune Martin (2005), *Corporate Use of Codes of Ethics: 2004 survey*, Institute of Business Ethics, UK.

KPMG's 2005 ethics research

The findings from KPMG's *Forensic Fraud Survey 2004*⁶, suggest many Australian companies struggle when it comes to the ethical dimension of their business.

Ethics in Australian workplaces⁶

- 33 percent of employees witnessed unethical or improper conduct at work during the previous two years.
- 22 percent attributed this to senior management's lack of commitment to the organisation's ethical code.
- 18 percent believed a poor ethical culture contributed to unethical behaviour.
- 24 percent felt the CEO was responsible for embedding a culture of integrity.

The contemporary governance mantra is that boards should set an appropriate 'tone from the top'. In a business ethics context, what does this mean, and how do Australian directors go about it?

To try to answer these questions, KPMG's Corporate Citizenship & Business Ethics unit undertook qualitative research involving key directors of some of Australia's top public companies. Twelve individual directors participated in the research. Between them, these directors sat on the boards of 45 major listed companies. Directors contributed their insights via an electronic questionnaire, or by interviews with KPMG's Dr Attracta Lagan. Confidentiality was guaranteed to encourage a candid expression of views. Direct quotations from participating directors have been interpolated into the document where appropriate.

The research findings have been supplemented with a review of relevant current Australian and overseas research on director accountability for business ethics.

In 2000 KPMG conducted a similar survey into board attitudes to business ethics. That survey found that Australian directors typically perceived that ethical standards were learnt outside the business environment, that training in business ethics was not the responsibility of companies, and that boards looked to peak business bodies for guidance on ethical standards.

KPMG's latest work suggests little has changed.

Setting the ethical tone

Asked to describe what role, if any, directors had in setting the ethical tone of the organisation, a majority of respondents believed the board's role was to lead by example, consciously demonstrating an ethical 'tone from the top'.

However, respondents were unanimous in their view that it was the CEO that played the key role in establishing the organisation's ethical stance. Some conceded that it was a shared responsibility between the board and senior management. Board interaction with the CEO - including CEO selection criteria, agreeing corporate values and cultural direction, setting ethically framed key performance indicators and maintaining ethical accountability - were important ways in which the board set the right 'tone'. Few believed the role of the board involved ensuring formal policy documents were in place and actively adhered to.

"The board and senior management establish principles for the organisation to live by – these are then captured in the organisation's code of conduct. The principles specify the types of behaviours expected and set out both inside and outside accountabilities. The way the board itself behaves sends a symbolic message about what behaviour is expected. Board leaks, inboard fighting, etc, also models a behaviour to the rest of the organisation."

Accountabilities

Respondents were asked if they thought the board had different ethical accountabilities from the rest of the organisation. Some felt the board should be held to a higher standard than others within the company. Others believed that while there should be no difference in principle, in practice there would be a difference, with the board being held to a higher standard. Yet others said there should be no difference at all.

“Absolutely not. To the extent that it does, the board should ensure its accountabilities are of the highest standard and then ensure the rest of the organisation is in alignment.”

Given intense media scrutiny of perceived unethical business conduct and dwindling public trust in business, respondents were asked if they had noticed any changes in their boards’ ethical accountabilities over the previous 12 months. Most perceived no change, although several pointed to increased attention to compliance and perception issues. Most were sceptical of the media’s objectivity in reporting corporate perspectives. They thought the news media was predisposed to approach directors’ explanations through the lens of pre-conceived prejudice. This makes it difficult to present a balanced perspective on complex issues which appropriately reflect the challenges and competing tensions facing business leaders.

“Politicians and the media love to see issues as having a devil, a victim and a hero. Real life is never that simple.”

Instances of corporate misconduct were thought to have made boards more sensitive to ethical issues. Ironically, this sensitivity had led to a greater emphasis on compliance and a ‘ticking the box’ mentality. Asked how directors viewed their responsibilities to stakeholders, many recognised that shareholder and other stakeholder interests were interdependent. For some directors, ethical responsibilities to stakeholders were regarded as an extension of the company’s products and services. For example, a finance company would consider consumer debt to be one of its stakeholder ethical accountabilities.

Ethics management framework

Less than one third of respondents reported that their companies conducted regular reviews of their ethical management frameworks. Indeed, while most respondents considered ethics an inherent input to board discussions, there was no explicit framework to ensure this happened. This finding is at odds with international research that suggests specific ethical reviews are required to keep boards on track to deliver their espoused values. It also sits in stark contrast with the elaborate financial and risk reporting that is typically a feature of every board meeting.

“Directors owe a duty of care to the company, and hence not just shareholders. Indeed, it could be said directors are failing their fiduciary obligations to shareholders if they fail to heed this principle.”

Internal and external triggers

Asked what drove boards to consider ethical issues, respondents reported a mix of internal and external triggers as set out in descending priority below.

1. Media exposure.
2. Staff turnover.
3. Remuneration reviews.
4. New board appointments.
5. Specific internal incidents.
6. Events at other companies.
7. Annual review of ethics policies.
8. Government policy.
9. New CEO.
10. Clash of stakeholder expectations.
11. Customer/supplier relations.
12. Behaviour of an individual director.

Although boards respond to particular events with ethical ramifications, there was a notable absence of proactive, formal board agenda time devoted to sustaining ethical commitments and frameworks.

"I suspect that this type of [board] reflection is usually triggered by an event, a crisis perhaps, and the reaction to it."

Policies and procedures

The research found little in the way of specific board-level policy for dealing with unethical behaviour. Instead, boards rely on their organisations' codes of conduct as the management framework for addressing ethical transgressions.

The research confirmed board dependency on CEOs to further the ethical agenda, to alert directors to ethical shortcomings in the organisation, and adjudicate on ethical conflicts within the organisation. The inherent conflicts of interest in these roles were not generally recognised.

Asked if there were particular ways in which boards encouraged executives to have regard to the ethical dimensions of business decisions, the responses indicated a reliance on informal methods such as topical discussions together with indirect methods, including compliance with articulated corporate values, corporate social responsibility reporting and performance in corporate reputation indices. Within their own deliberations, most respondents conceded that discussions on ethics were driven by specific events, and that ethical issues were intuitively reviewed rather than articulated as a separate agenda item.

"A code of conduct exists for staff, but in the case of a director it would be difficult to deal with due to the method of appointment and the operation of the Corporations Law."

“By ensuring directors are aware of the law, the spirit of the law, the code of ethics, the values and lastly, but by no means least, the importance of plain, honest, open, constructive communication, discussion and decision making with no hidden agendas.”

Identifying ethical issues

Although one third of respondents admitted that they lacked mechanisms for identifying and dealing with ethical issues, many pointed to cultural factors such as free-flowing communication between directors, management and staff. One third suggested ethical issues emerged from the application of board charters, codes of conduct, staff surveys, reports from internal and external auditors and the annual discussion of externally generated issues.

“Focus on short-term returns and profitability - boards can only do ethics if companies are seen to be profitable.”

In this context, KPMG’s findings are similar to those obtained by BT Governance Advisory Services.⁷ BT found that many of the top 200 listed Australian companies failed to disclose ethical risk. Its research tested more than 150 indicators of ethical risk and revealed that 83 percent of companies had no board oversight of unfair business practices such as price-fixing or insider trading. Companies penalised for bad behaviour did not necessarily improve their conduct.

Both KPMG’s and BT’s findings suggest Australian boards cannot take ethical business practices for granted. Rather they need to be actively promoted, measured and rewarded (or penalised) in a similar way to other organisational behaviours.

Reputation stewardship and measurement

KPMG sought to discover if Australian directors were systematically tracking public perceptions of their reputation. Responses suggested that this was not generally happening. Where reputation was being tracked, it was often incidental to other research. Those that tracked their reputations usually relied on public reputation indices. Organisations that did not monitor their reputation gave a variety of reasons for their stance, including a belief that effective reputation tracking mechanisms did not exist, their assumption that their ethical reputation should be self evident, or that board members were opposed to such tracking initiatives.

A ‘sunlight test’ is often used in ethics training to help participants understand how their actions might look if reported, say, on the front page of a newspaper. KPMG adapted this test to ask directors whether they felt all of their board decisions and practices would withstand media scrutiny. Most respondents felt their boards would pass this sunlight test. Of these, almost half qualified their response with the proviso that ‘the media got it right’.

⁷ Research commissioned in 2005 by BT Governance Advisory Services on behalf of several major superannuation funds.

Ethical challenges

Canvassed on the main ethical challenges facing their boards today, respondents nominated three key issues.

1. Maintaining a single focus on enhancing shareholder value at the expense of all else.
2. Adverse media coverage and reputation risk.
3. Executive remuneration.

Participating directors were also asked what they saw as the most important general ethical concerns today. Responses reflected the influence of the news media, with such media hot buttons as community expectations, executive remuneration, political donations and human factor issues such as work/life balance all receiving multiple nominations.

“Understanding and defining ethics is a major challenge. Whilst the word ethics is rarely if ever discussed specifically, boards and executives do generally understand the importance and fragility of reputation.”

A chairman's perspective

Board chairmen are expected to take a lead in shaping board attitudes on a range of matters, including issues of ethical business conduct. It is the ultimate 'tone from the top' role.

It is reflected in their conduct of board meetings, their ability to influence the content of board agendas, their relationships with other directors, and their interaction with CEOs and other senior executives.

In early 2005 the Centre for Research into Ethics and Decision Making in Organisations (CREDO) surveyed the views of 32 Australian public company chairmen for the Australian Council of Super Investors.⁸ CREDO's main finding was that while adverse media exposure of ongoing corporate scandals had sensitised Australian board chairmen to ethical issues, they were yet to translate this awareness into boardroom action. The chairmen surveyed believed that board ethical accountability was an extension of personal morality, and that ethics training for board members was not necessary. Nearly three quarters of CREDO's respondents felt directors already possessed the necessary skills. Only 18 percent said their companies provided ethics training during director induction. However, 80 percent claimed their boards had discussed ethical matters over the previous 12 months.

"Leaders aren't intrinsically good people and certainly not heroic. Most are driven by feelings of inadequacy, insecurity and what can only be described as over-ambition."

Lord Stevenson, Chairman HBOS, 2005

Maintaining ethical standards

Whilst 93 percent of the companies covered in the CREDO survey had policies that promoted ethical conduct, it was far from clear that these policies applied to the board itself. Similarly, while the great majority of companies had a mission or values statement, just 30 percent required directors to sign up to these standards, and only 57 percent applied them in board decision making. Few measures were in place to determine whether companies were complying with their own codes of conduct with a majority companies not reporting performance against indicators to their boards. Only seven percent of chairmen were trained in applying their codes of conduct, and only 15 percent could think of examples where the code of conduct had influenced or changed corporate practice. CREDO confirmed KPMG's finding that the Board believed CEOs were primarily responsible for setting and maintaining ethical standards.

Most respondents to the CREDO survey viewed compliance with the ASX corporate governance guidelines as the ultimate ethical goal rather than as a minimum baseline for governance activity.

CREDO noted the lack of research supporting the assumption that directors hold ethical positions congruent with their boardroom colleagues and with the community at large. This makes it impossible to verify whether the ethical standards subscribed to by company directors reflect broader social norms. Could it be that the ethical expectations and values of directors differ from those within the wider general community?

CREDO concluded that "effective governance is a function of the trust in which the board is held by those outside the company". CREDO thought that if this definition was valid, then its research indicated that Australian boards were failing the governance task.

Conclusions and implications

The research presented in this paper provides some timely insights into the elusive dynamics driving board perspectives of the ethical dimensions of corporate life. It identifies some of the obstacles to a more robust engagement with modern day ethical challenges - challenges that arise from the idea that business is essentially a social institution that is responsible for its social and environmental footprint as well as its economic performance.

As far as most Australian boards are concerned, ethical issues remain an individual rather than a collective issue. Whilst the majority of Australian boards recognise their accountability for encouraging an ethical organisational culture, they still feel the real responsibility for this remains with the CEO. Yet there is little evidence that boards have made ethical stewardship a specific key performance indicator for the CEO, or to more broadly assess CEO performance in this area, either in job descriptions, performance reviews, organisational ethics audits, or dedicated policies and procedures. The risks of this approach are exacerbated by diminishing CEO tenure, which creates the potential for an abdication of ethical responsibility in pursuit of immediate results, or the development of an 'expeditious ethicality'.

For the moment, day-to-day ethical accountability remains in the too-hard basket. It is promoted informally and indirectly through boardroom discussions, personal role modelling and voluntary adherence to organisational codes and values. Training in these protocols is limited for boards and the wider corporate workforce. In many companies ethical accountability has been subsumed into the human resources' function where it has become a largely compliance driven task.

KPMG's latest research found that boards are typically concerned at their inability to reassure the news media - and through it, the Australian public - of their concern to promote and safeguard ethical business standards. The media is a convenient scapegoat here, but not necessarily a convincing one. Perhaps implicit in this concern is a widely held but generally unstated belief that business culture and business ethics are inherently chaotic and unmanageable social phenomena that preclude the precise measurement and monitoring that characterises most other aspects of business. Few boards seem willing to challenge this proposition.

Corporate crimes and scandals remind us of the fragility of business ethics. Yet boards continue to rely on the personal moral standards of their members rather than treating business ethics as a collective responsibility beyond individual predispositions. Clear statements of, and commitments to, ethical business principles can act as a powerful counterweight to the rampant pursuit of individual gain or self-aggrandisement within the corporation. There is little disagreement that it is the board's role to lead this process and set the necessary ethical 'tone'. Boards that step up to this challenge ensure that the business is driven by a set of shared principles that offset the absence of universal moral principles.

Outstanding ethical challenges for boards

Externally

- Articulate a clear distinction between individual morality and business ethics and what this means for boardroom and organisational ethical accountability.
- Encourage peak business bodies to participate in the public business ethics debate to rebuild public confidence in business.

Internally

- Recognise 'corporate culture' as the social life of the organisation that defines how people make decisions and behave.
- Develop a clear board policy on how you intend to set the required 'tone from the top', that is, what the organisation's business ethics will look like and how they will be evaluated.
- Specify the interrelationships and role accountabilities between the board and CEO for maintaining ethical standards together with clear organisation key performance indicators that will allow performance monitoring.
- Separate organisational cultural management from compliance processes.
- Identify the different models of corporate social responsibility around the world, developing board principles on key issues of public concern, including executive remuneration, global supply chain accountabilities and intergenerational environmental equity.

"There is nothing more difficult to carry out, nor more doubtful of success, nor more dangerous to handle than to initiate a new order of things."

'The Prince', Machiavelli

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