The importance of corporate integrity

WHILE THE CLIMATE FOR M&A HAS IMPROVED, THE IMPORTANCE OF CORPORATE INTEGRITY HAS BECOME EVEN MORE PARAMOUNT. AS RECENT EXAMPLES OF CORPORATE MALFEASANCE HAVE DEMONSTRATED, FINANCIAL INSTITUTIONS THAT HAVE INTERESTS IN LARGE CORPORATIONS ARE HEAVILY STAKING THEIR ECONOMIC RETURNS ON THE INTEGRITY OF THOSE COMPANIES, STARTING WITH THE INTEGRITY OF THEIR BOARDS OF DIRECTORS.

Companies that seek to make acquisitions or to form mergers should heed to recent history and realise that the corporate integrity of their targets is a significant factor to consider before making any level of commitment.

This article discusses the commercial importance of corporate integrity and provides a number of suggestions for M&A professionals in their consideration of due diligence, not just as an audit process but as a penetrating look at the people, groups of people, relationships and dynamics that often determine corporate (mis)behaviour.

Corporate integrity

The first question that invariably occurs to an executive when confronted with the subject of corporate integrity is: “Why is this relevant to the success or failure of my company?”

In the investment world, the question is similar: “Why is corporate integrity relevant to my current/potential investments?”

The answer is simple: without integrity, companies will fail, albeit probably in the medium to long-term. Corporate integrity is therefore vital to corporate success or failure and integral to the due diligence process carried out by any potential investor, acquirer or merger partner.

Furthermore, in the commercial and investment worlds there is a misconception about its meaning. When encountering the term, executives typically interpret it to mean “corporate social responsibility” and do not attach to it the strategic significance of “corporate longevity” or “corporate viability”.

A clearer understanding comes from considering the questions:

• Is it possible to align management systems with both the commercial goals and values of a company?
• Is it wise to consider one without the other?

Corporate integrity is about enhancing a company’s viability, competitiveness and longevity by aligning commercial goals with honest, transparent ways of doing business throughout the company. Misinterpretation or ignorance of the commercial reality of corporate integrity may fatally damage a company. Its adoption into mainstream strategy and management processes will enhance success.

A company’s conduct is a measure of its integrity and this conduct is informed by:
• Core values practised throughout the company, ie, its ethics
• Commercial capabilities of generating revenue and profits
• Assessment and management of risk
• Consideration of the surroundings and the stakeholders on which it relies for its existence

Consider the most infamous example of a failure of corporate integrity (and a situation that any investor or acquirer will be keen to avoid): Enron. The collapse of Enron was a direct result of financial misrepresentation and fraud but the key to this collapse was not the fraud itself but a culture of a lack of integrity or ethics, germinating at board level and permeating throughout the company.

Former Enron executive Lynn Brewer elaborates: “Being a ‘bad apple’ at Enron meant a promotion,
Reputation is fundamental to a corporation: without a positive reputation a company would have no customers, no brand value and, ultimately, no profits. Reputation attracts and retains resources to companies and furthers their operational capabilities. In 1998 Interbrand, the global branding consultancy, calculated that some 71% of the market value of FTSE 100 companies was represented by the intangible value placed on brands and public reputation. Furthermore, in 2001, Interbrand calculated that 96% of Coca-Cola’s stock market value lay in intangibles such as reputation, knowledge and brand, while the stock market value of the intangible assets of Kellogg’s was estimated at 97% and those of American Express at 84%.

With such a significant proportion of their value tied up in this area, the continued existence of many companies is highly vulnerable to reputational damage resulting from intense scrutiny of their corporate integrity practices. The most accepted way of measuring reputation is based on stakeholder opinions defined by a series of criteria. Those stakeholders that are consulted are those that hold resources that are critical to the company’s survival:

- Employees: who grant expertise, leadership, and commitment
- Customers: who purchase company products and can demonstrate loyalty and positive reputation
- Investors: who provide financing
- Communities/General public: who offer infrastructure and a location and welcome corporations to the neighbourhood

These groups frequently judge a company on how it communicates and links corporate integrity with commercial strategy. Studies show that an increase in reputation, measured in this way, results in an increase in market value (and vice versa). Reputations, which are won with difficulty, can be lost with ease, particularly when companies are exposed to unwelcome media scrutiny by dissatisfied stakeholder groups. Media campaigns over recent years against Gap, Wal-Mart, McDonalds and Nike are good examples of the scale of such campaigns.

A demonstration of the long-term effect of such campaigns is shown in the case of the Exxon Valdez Alaskan oil spill disaster. The Exxon Valdez tragedy took place over 15 years ago, on March 24 1989, yet the company continues to receive low grades when it comes to its environmental reputation from a large proportion of respondents, with some of those surveyed even extending their views to the company’s 1999 merger partner, Mobil. This is an interesting example, showing how the reputation of one company can be transferred, positively or negatively, to the acquirer, merger partner or even the investment company.

For potential acquirers and investors, the transfer of a company’s reputation, for good or bad reasons, should not be the only consideration of risk or advantage. The other is the working culture of the company that is bound to spread, in one way or another, once the transaction or the deal is complete.

“...dramatically clear that the foundation of corporate integrity is personal integrity.”

Samuel DiPiazza, CEO, PricewaterhouseCoopers

If the company’s employees are accustomed to a way of conducting business that is perhaps less scrupulous than those of the interested party, then this corrupt culture will spread. The potential damage from this was understood by Dynegy Inc, the company with which Enron attempted to merge shortly before its collapse, when it terminated talks at the last moment.

**Integrity due diligence**

In the due diligence process, therefore, corporate integrity must be assessed. The issue, though, is one of measurement, as analysts currently find it difficult to measure non-financial contributors to corporate success and performance.

The diagram above shows some of the key criteria assessed by long-term institutional investors and by M&A analysts in their decision-making. The criteria shown in blue (social/environmental factors and corporate governance) indicate two of the areas that have grown in importance in the minds of analysts in recent years. While there is continued focus in these two areas and a maturing ability to measure them, they do not
remove the potential for investing in “the next Enron”. The main reason for this is that corporate governance, in order to be “measured”, is typically relegated to box-ticking, leaving the analyst satisfied with the integrity of a company based on its demonstration of a basic compliance structure.

This is of course misleading. Traditional approaches to risk management and integrity assessment are no longer applicable. Most analysts do not have the dedicated resources to assess the complex accounting, legal and personnel issues that are central to an assessment of corporate integrity. And the new corporate governance rating services cannot possibly capture the contextual subtleties of complex issues with their “box-ticking” approach.

Enron is a good example of a company that observed the corporate governance rules but was brought down because of a failure of ethics. It knew how to act, but not how to think. The company, on paper, had an excellent code of ethics, a climate change policy and was a generous supporter of philanthropic causes. One of its board members even lectured on the importance of business ethics.

The company collapsed not because it obeyed the “rules” but because of the inconsistent ethics of many of its executives. The Enron culture told employees and stakeholders a very different story about the ways in which business could, acceptably, be conducted.

So, how can corporate integrity be assessed? The following factors should be considered in the due diligence process of any analyst:

- Does the target company have a central code of ethics/practice? How old is it? Was it compiled in consultation with employees and other stakeholders?
- How effectively does the CEO communicate with the chairman? If there is no chairman, how objective is the CEO?
- Does the supervisory board agree on the corporate stance on integrity?
- Are values communicated clearly throughout the organisation? Is it possible to interview a number of employees to assess this? (not just in HQ!)
- Who has key responsibility for maintaining corporate integrity? Is this individual's authority sufficient?
- What training procedures does the company have in place on corporate integrity?
- Is integrity an element of the selection process for new recruits?
- What procedures does the company have in place for whistle-blowing? How is this managed?
- What crisis management and security procedures does the company have in place?
- How does the company communicate with its key stakeholders?
- Has the company clearly identified its key stakeholder groups and prioritised their considerations in line with the company’s commercial goals and values?
- How does the company communicate its commercial goals and its stance on corporate values to its stakeholders?
- Are the company’s values and non-financial goals aligned with those of the acquirer? Will this affect the viability of the latter post-acquisition and will it also affect key stakeholder loyalty to either the target brand or to the acquirer’s brand?
- Where does the target company operate? Does it comply with all national regulations and legislations?
- Does the company have procedures in place to negotiate the complexities of differing national corporate governance regulations and legislations?
- Will involvement with this company affect corporate governance compliance regulations? For example, a merger between a UK and a US company may result in complexities with the 2002 US Sarbanes-Oxley Act.

“The reality is that examining who you are doing business with is essential pre-investment homework.” - Toby Latta, Director, Corporate Investigations, Control Risks Group

With which business partners and agents does the acquiree work?
Are these partners reputable and trustworthy? Have they been assessed in the due diligence process?

Conclusion
The case for any organisation to pursue corporate integrity with an explicit strategy is clear. In an age in which, arguably, there has been too much focus on short-term results and the need for instant return, an age is dawning in which enlightened leaders in the business sector and the investment community will seek to deepen and strengthen the fundamental pillars that support any organisation and lend it integrity and long-term strength and viability.

The business case for this is not impossible to make. Experience demonstrates that being value-focused and prepared to integrate values into mid-term and long-term strategic thinking pays dividends and increases competitiveness.

Equally, there are examples aplenty in recent corporate scandals of the dangers of not doing so.

Companies that are seeking to make an acquisition or investors that are seeking to invest in an organisation must consider corporate integrity seriously and failure to do so dramatically increases the risk of being involved in or creating the next major corporate scandal.

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Footnotes
1 CriticalEYE REVIEW, June 2004
2 This is the CriticalEYE Corporate Integrity Model™ developed by CriticalEYE based on its Six Pillar theory of complete corporate integrity.
3 For a guide to measuring reputation, refer to http://www.harrisinteractive.com/expertise/reputation.asp
4 The Reputation Institute (www.reputationinstitute.com) and Harris Interactive (www.harrisinteractive.com)
5 Wall Street Journal, 7th February 2001
In 2001, a third of analysts consider social and environmental issues to be an important factor in helping them assess companies (Association of British Insurers, 2003) and most analysts now incorporate corporate governance into their criteria.