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The intersection of conduct culture and company value

Susheela Peres da Costa

Overview

The ethical conduct, trustworthiness and 'social licence to operate' of a company matter to the community and consumers, especially in a post-GFC world. But what about shareholders? They want their investments to perform financially, but such community expectations have meant the days of performance at any cost are long gone.

Instinctively we know that reputation and brand is valuable. Today, we know a poor conduct culture or an absence of ethics at a company will result in its social licence to operate being revoked. This diminishes the company's reputation and brand, and ultimately its value.

Yet, these concepts are difficult to measure. Indeed, brand, reputation and social licence to operate are off balance sheet assets. To underscore the importance of what lies off the balance sheet, one need look no further than the off balance sheet *liabilities* that caused corporate collapse at the likes of Enron.

In other words, off balance sheet assets constitute a company's intangible value. While these assets add value, they are difficult to measure and so tend to remain largely ignored by accounting standards, resulting in intangible value mostly going unrecognised in statutory balance sheets. This is slowly changing, however, with the uptake of integrated reporting <IR> in recent years, a framework which includes guidance on accounting for intangible value in mainstream filings.

Importance of intangible value

Today, intangible assets – including social licence to operate – represent a significant proportion of the value in Australian listed companies. Based on our estimates, book value represents only around half of current market value for the S&P/ASX200. Research in the US has estimated book value represents less than 20% for the S&P500.[1]

This unrecognised proportion of market value has grown with the decline of manufacturing and resource sectors, and the increasing representation of businesses that create significant value from brands, intellectual property, reputation and human capital.

Because the way in which intangible assets translate to financial value in companies is less easily quantified, it receives relatively scant attention in corporate communications to investors. With limited information available to inform assessments of a company's true value and outlook, the market's recognition of and reward for investment in superior practices remain imprecise and unevenly distributed.

However, this is problematic because superior conduct – and conversely poor conduct – can significantly impact the long term value of a company, especially as conduct affects brand, reputation and social licence to operate.

The poor conduct link to value destruction

We recently partnered with Dr Darren Lee to understand how Regnan's scores across each of the environmental (E), social (S) and

governance (G) factors we consider have been reflected in the performance of the ASX200 companies assessed, over the period December 2007 to December 2016.

The analysis found a positive correlation between high quality management of the risks that can impact intangible value and company performance over that period. A full report will be launched before June.

Given the current interest, we have pulled out the results on ethics and conduct culture below. The factors assessed to gauge company responses to conduct risks are outlined in the Appendix.

Based on our assessment methodology, over the testing period:

- The majority of ASX200 companies are managing their ethics and conduct risks, to the extent that robust controls are evidenced for relevant company ethics and conduct exposures (scores of 3, 4 or 5).
- Where Regnan had 'high conviction' on ethics and conduct performance (i.e. high scores of 4 or 5), however, the results suggest market performance deviates significantly from the ASX200 benchmark.[2]

The testing showed that those companies that managed conduct culture well (i.e. those companies with a score of 4 or 5) significantly outperformed those companies with low scores. We also found high-scoring companies outperformed the S&P/ASX200 index over the testing period, as shown by the chart below. Conversely, low scoring companies significantly underperformed the ASX200.

The vertical axis in Figure 1 shows how the two portfolios would perform with an initial investment of $100. The graph lines are created by simply aggregating the share price returns (updated monthly) for the group of stocks held in the high or low scoring portfolio.

The stocks we rated highly (4 or 5) represent a subset of the ASX200, and the performance of this group of companies, *in aggregate*, will have performed as shown in the chart for High ESG Score companies. Likewise for the companies which scored 1 or 2 for Low ESG Score companies.

Examples of good practice

As part of the regular update of our ASX200 ethical conduct assessments, Regnan seeks to identify companies with strong conduct controls to provide good practice benchmarks. A notable characteristic of leading companies is continual upgrading of conduct controls in response to changes in the business risk environment, or to internal control failures. We highlight two companies below which stand out on the strength of their conduct controls.

CSL Ltd (CSL)

As a global healthcare company operating in multiple jurisdictions, CSL is exposed to material reputation risks relating to compliance with regulations and industry standards encompassing trade practices, anti-kickback regulations, bribery, and consumer protection. While it maintains a strong record on conduct, CSL has experienced conduct related events in the last decade. However, the company's response to previous events sets it apart. Notable are continuous improvements to ethical conduct controls including:

- A robust business integrity management system incorporating clear expectations of employees, compliance systems, employee awareness, measurement systems and management actions where breaches occur.
- Clear behavioural expectations are communicated to employees, with detailed guidance provided to employees for role-relevant ethical decision making scenarios.
- Integration of business integrity risks within the enterprise risk framework, with oversight by the CSL Audit and Risk Management Committee.
- Inclusion of conduct/reputation management in executive remuneration structures.

Oil Search Ltd (OSH)

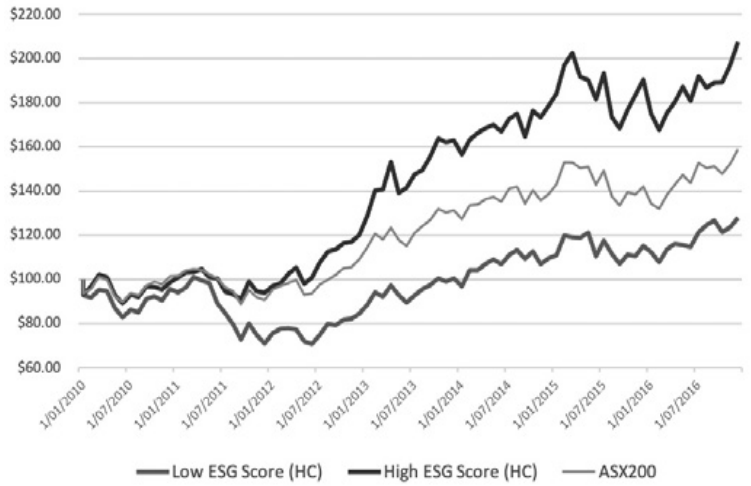
With operations focused in a very high risk jurisdiction (Papua New Guinea), OSH is highly exposed to corruption and bribery, as well as sensitive community stakeholder relationships, which elevate ethical conduct risks. National governance challenges and lack of enforcement structures in PNG compound these risks. OSH ethical conduct controls stand out on:

- Clearly articulated expectations of employees with respect to giving or accepting of gifts, facilitation payments, or any payments which breach corruption and bribery standards. Corruption prevention procedures are regularly updated to reflect best practice.
- Comprehensive training of employees on conduct standards. For example, OSH reported that 99% of employee and on site consultants had completed corruption prevention training in 2016.

The quote

A poor conduct culture or an absence of ethics at a company will result in its social licence to operate being revoked.

Figure 1. Ethics & Conduct Tilt Portfolios - High Conviction
Jan 2010 - Dec 2016



Source: Regnan and Dr Darren Lee

The quote

Protecting company value, and indeed supporting growth, requires strong ethics and conduct performance

- Strong oversight of conduct by the board. For example, ethical conduct training completion rates are monitored by the Board Audit & Financial Risk Committee, and performance on ethical standards is included in executive remuneration.
- Reporting on actions taken where material breaches to ethical standards occur.

Protecting value through conduct culture

Conduct culture represents a material component of intangible value. Indeed, Australian regulators and business leaders have recognised the importance of culture in shaping behaviours and decision making throughout an organisation, and have sought to promote specific attention to the subset of organisational culture which shapes risk taking and ethical conduct – put simply, conduct culture.

Conduct culture focuses on the aspects of workplace practices that influence how individuals react when faced with choices which have ethical or compliance dimensions, as well as how they behave in relation to organisational values, risk settings, and stakeholder and community expectations. For example, how an employee might approach conflicting interests of different stakeholders, whether they may be tempted to deprioritise a compliance guideline in order to meet a sales target, or how persistently they may seek to have conflicts of interest or other concerns addressed. A poor conduct culture is manifest when deviant behaviour becomes normalised.

We want to see that it is not just about controlling employee transgressions against the company, but also the **company's impacts on others** (e.g. customers, the community).

We want the focus to be on **ethical performance, not just legal or other compliance**, and see that the performance standard is responsive to community standards/expectations.

We want these standards to apply to **executives and directors** – not just employees – and to encompass their **strategy and management decisions**.

Strong conduct controls and the role of the board

As part of Regnan's company evaluations relating to ethical conduct, we have found certain controls and incentives to be best practice and most likely to support robust conduct culture. Stewardship of the conduct culture of a company should be a key function of its board, especially when the average tenure of a CEO in Australia is only five years. There is a strong case for boards to take an active role in relation to conduct given its strategic importance and the evidence that misconduct can destroy company value.

We view positively corporate ethics policies established as a result of deliberative board consideration of the ethics issues which they address, and encode the board's determination as to how the company and its employees should handle those matters. Also positive is the board being attentive to potential misalignment between strategic objectives, risk appetite and incentive structures.

This means that effective board policies:

- Clarify consistent expectations for employees, contractors and other stakeholders;
- Provide the standard against which the adequacy of management, monitoring and reporting arrangements for ethics issues can be evaluated;
- Empower employees and stakeholders to act in line with policy (when faced with competing demands) and a means to escalate areas of concern in order to provide feedback to the board about friction points that may be emerging.

As stewards of conduct culture, it is central that the board maintains clear oversight of the internal application of policies and controls. This requires information flows from senior management to the board, and involvement by the board in setting the tone for a culture that encourages 'speaking up' when misconduct or other concerns arise.

Conclusion

Though hard to account for on the balance sheet, intangible assets make up a significant proportion of a company's true value. This intangible value includes brand, reputation and social licence to operate – all of which are sensitive to poor conduct. Protecting company value, and indeed supporting growth, requires strong ethics and conduct performance. This had been confirmed by testing of Regnan's research which shows companies with poor performance in this respect have performed below the ASX200 average, while those with strong conduct have outperformed the index over the testing period. Achieving strong conduct requires a robust conduct culture which supports ethical decision making, not just legal compliance, and consideration of community expectations to preserve brand, reputation and social licence to operate. The board is best placed to be stewards of conduct culture. FS

Appendix

Regnan assesses ASX200 companies on the robustness of controls in place to mitigate *company specific* ethical conduct exposures. Company controls assessed include:

Code of Conduct

- Specific ethical conduct exposures
- Whether it covers all employees and relevant contractors
- Guidance for employees (e.g. examples and scenarios)
- Whether it is updated regularly to address changing business risks Recognition of ethical conduct risks
- Inclusion of ethical conduct in strategy/strategic statements
- Inclusion in risk management frameworks (e.g. risk management policies, Risk Committee Charters)

Whistleblowing system

- Alignment with best practice design (anonymous, confidential, available to all employees, including all business divisions)

Oversight

- Board and senior executive oversight of ethical conduct (e.g. receipt of regular reports on compliance with legal requirements and standards)
- Dedicated board level committee(s)
- Executive remuneration linked to performance on ethical conduct

Management actions on breaches of ethical standards and policies

- Evidence the company investigates breaches
- Actions to maintain compliance with standards and policies

Notes

1 Ocean Tomo

2 Regnan scored companies a 1 or 2 for ethics and conduct about 32% of the time, meaning conduct controls are poor relative to conduct risks. Companies who received a 4 or 5 over the testing period were those who we identified as managing their potential conduct risks well with strong controls, including, for example, clear board oversight. Regnan scored companies a 4 or 5 only 14% of the time.