The Value of Integrity

By Lynn Brewer

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How many business leaders today believe they have learned the lessons taught by Enron? That the Enron story is simply one of failed corporate governance - the oversight necessary to maintain the compliance and ethics of an organization? What if I told you presently 50,000 whistleblowing reports are made every month to the SEC - compared to 6,400 per month the year Enron imploded? What if I were to tell you today 90 of the Fortune 500 companies could possibly be cooking their books - would it make you wonder whether business leaders should take a second look at the issue of integrity?

Redefining Integrity:
We have been misguided to believe integrity equates to ethics and thus if you have solid corporate governance policies - the integrity of the organization is sound. Although certainly compliance, ethics, and corporate governance are part of an organization's integrity, we must expand our approach. If, for instance, we were to approach organizational integrity the way a structural engineer examines the structure of a building, we would realize the issue has far less to do with policies and procedures and more to do with overall soundness of the business and its ability to withstand market forces.

Integrity, originating from the word "integer" (a whole number), in its simplest form means: "soundness, wholeness, and incorruptibility." When we realize hundreds of companies have proven to operate with the same level of integrity as Enron, we begin to understand the need of stakeholders to have a way of separating the wheat from the chaff - the Enrons from the others. And equally important, companies need to have a way of differentiating themselves as something other than the next Enron. As this is achieved, companies gain shareholder confidence and shareholders gain the financial benefit of a greater ROI.

Measuring Integrity:
There are several arguments that exist today as to the importance of integrity. However, despite those companies seeking to "do the right thing", there has been no standard means by which we can gain any sense of assurance whether a company has integrity or not, much less a quantifiable measure as to the specific level of integrity. The company may be compliant with Sarbanes-Oxley, while the competency of the leadership may be questionable, their compensation excessive, and the culture of the organization dysfunctional, none of which are in violation of the law but all of which may ultimately destroy the value of the company.

By understanding the factors that impact the quality of financial reporting, business leaders can begin to demonstrate the level of integrity under which they operate. For instance, when the CEO communicates with shareholders does he or she do so with the intent of putting a spin on the truth - obscuring the facts - or do they do so with the intent of embracing full transparency?

Of course, most believe annual letters to shareholders are prepared by investor relations and/or public relations professionals, and thus pay little or no attention to them. However, we need only look at the case of Enron to realize the importance of the information contained therein, and the damage caused to investors from the failure to further examine the content of the letter.

In Enron’s 2000 Letter to Shareholders, CEO Jeffrey Skilling stated the company had hit a record "$1.3 billion in net income", yet the audited financials were clear - Enron had reached only $978.5 million in net income. There were no footnotes, no further discussion of the discrepancy, and yet every reference by the media or analysts from that point forward stated Enron was a $1.3 billion company - no questions asked.

Moving to the issue of compensation, clearly the packages at Enron were excessive, but Enron is clearly not alone in its excessive pay. While certainly executives that build long-term value of a company's assets for investors should be recognized and rewarded, we must also

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understand the negative impact on the integrity of a company by rewarding an executive, or any employee for that matter, with a package that is based upon false reality or performance that can be manipulated. Additionally, leaders must recognize the cultural destruction that can occur for any leader who fails to recognize the disparity between their own compensation packages and that of those they seek to lead - particularly if leaders are out of touch with the culture of the organization.

Meanwhile, CalPERS and TIAA-CREF, two of the largest institutional investors, have both created policies they consider for fair and just compensation of executives. As excess compensation is seen as a lack of good corporate governance, institutional investors have said they will "punish" companies with excessive compensation packages, by withholding their investment dollars. Given that the SEC has issued its own guide to executive compensation for investors, it is likely that this issue will remain a hot-topic for many years to come.

Examining the issue of compliance and ethics, we must recognize the issues have far more to do with business intelligence than simply "doing the right thing". To detect violations of laws and policies, reducing the risk of exposure, the company must have a confidential and anonymous reporting solution. While such a system is required for employees of publicly-traded companies to report under Sarbanes-Oxley, the SEC has suggested it not be limited to employees only. To maintain the confidence of the reporter and the integrity of the system, companies must outsource there reporting solution. The system must be available to all stakeholders via a secure Internet site, telephone and/or mail. Beyond that the reporting solution should meet the criteria established and defined for all business intelligence systems.

Addressing the financial impact of confidential and anonymous reporting, the Association of Certified Fraud Examiners recently published its study showing "The median loss among organizations with anonymous reporting mechanisms was $56,000, while it was more than twice as high for those that didn't have established reporting procedures." The study further concluded "Among cases that were detected by a tip, 60 percent of tips came from employees, 20 percent came from customers, 16 percent were from vendors and 13 percent were from anonymous sources." Despite the new legal requirement for a confidential and anonymous reporting system, it is obvious based upon the alarming rate at which employees are reporting directly to the SEC, they don't trust the integrity of the systems put in place by companies. Clearly, through a review of these reports, companies can understand the integrity of the organization in the area of compliance and ethics and determine whether corporate governance policies need to be revised. Beyond that, the new law prohibits retaliation against reporters and requires "treatment" of the problems which may clearly expose companies to additional liabilities if they fail to analyze the reports being made.

With the passage of Sarbanes-Oxley, many companies have been forced to undertake a review of their corporate governance policies. As organizations like Institutional Shareholder Services and The Corporate Library are measuring this aspect of corporate integrity, many companies today are realizing the impact to their shareholder value as investment decisions are being made based upon these ratings.

Of course, many leaders falsely believe corporate governance is a fad, yet, according to a recent study by The Ethical Corporation magazine, 85% of senior finance professionals say the issue of governance will remain on their firms' agenda for at least the next 18 months. The referenced survey defined business governance as a three-pronged approach: corporate governance, corporate performance management, and corporate social responsibility. And in fact, 60% of respondents said they were making "real and significant changes to business...
processes" with this new emphasis on corporate governance.

When it comes to reporting "non-financial" information, like corporate governance policies, we realize it is now becoming mandatory to report corporate social responsibility policies in many countries. The European Commission's Internal Market Commissioner Frits Bolkestein made it clear, the reason this information is now required is because "Investors need transparency if they are to be able to make informed decisions to benefit the economy as a whole by making sure that capital goes to companies who deserve it".

As we move to understanding the value of integrity and the impact non-financial information can have on shareholder value, companies should also look to the importance of stakeholder perceptions.

Interestingly enough, according to the 2003 LRN survey, 80% of the general public indicated their perceptions of a company's compliance and ethical behavior had a direct influence on their purchasing decisions. Rather than maintaining a myopic view of our organizations, employees, customers, vendors, and shareholders may provide insight that business leaders fail to recognize. The board of directors may understand the business from management's perception but do they understand the reality of its investors and customers.

Finally, companies need to address their business intelligence. The Integrity Institute measures the company's ability to understand its own integrity through the factors listed above, as well as its risk analysis and business intelligence systems. A "forward looking" formulation that is predictive is used to assess operational risk, as well as assess the company's business intelligence systems.

For instance, to demonstrate integrity (soundness, wholeness, and incorruptibility), the company's business intelligence systems must meet all of the following to be certifiable: 1) Functions and technologies across the organization must be integrated; 2) Adaptable and understandable for technical and non-technical business users that makes data available to anyone who needs the information, in a format that is relevant to them; 3) Data must be complete and comprehensive in an end-to-end platform, meaning all components of every system must be integrated; 4) Capable of performing analytical insight into the future rather than a review of the past through historical query and reporting; 5) Accurate and uncompromised data can be validated, even when multiple systems, disparate data sources and applications are integrated; and 6) Uncompromised storage capabilities that are secure and allow for quick and accurate retrieval of information.

After examining the above non-financial factors, the information needs to be validated against the financial information such as whether the likelihood exists that the company's earnings have been manipulated, which we do through using a variation of the Beneish Model.

Although many companies have used a number of approaches to measure the level of integrity within their organization, including the Balanced Scorecard, many leaders today are still struggling with the ability to communicate the value of their integrity to investors. While at least 94% of executives, according to the 2003 LRN study, believe that ethical companies are generally more efficient and better run, naturally lending itself to a greater ROI.

Lacking the ability of executives to communicate the level of integrity they maintain, companies are subject to the perceptions of institutional investors, 89% of which said they would pay more for the shares of a well-governed company than for those of a poorly governed company with comparable financial information according to the recent McKinsey Investor Opinion Survey of 200 Institutional Investors. The Integrity Institute's certification as to corporate integrity, similar to the Underwriter's Laboratory certification of consumer product safety, is just one of the many ways that companies can communicate they are not another Enron.

Of course, to fully make the argument as to the benefits of measuring and certifying corporate integrity, one must understand the financial benefit, as well as the impact to such things as the cost of goods, cost of capital, and shareholder

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As the move is being made by investors to look beyond the balance sheet as the basis for investment decisions, we find they are moving from the standard measurement of ROI: return on investment to a return on integrity. That's not to say the balance sheet and the financial analysis will not remain an important aspect of investment decisions, it's that institutional investors are beginning to recognize the role non-financial information plays in the process. In fact, according to a survey conducted by Cap Gemini Ernst & Young Center for Business Innovation, "roughly a third of investors' buying and selling decisions depend at least in part on non-financial information."

While study after study shows that there is a "clear negative correlation between levels of corruption (as perceived by investors) and levels of investment", there are those business leaders who are still of the opinion "and this too shall pass", thereby failing to meet the demands of shareholders simply because they believe they are not "corrupt". However, there are those leaders who are not naïve. Take Jeffrey Immelt, CEO of General Electric for example. In his 2002 Letter to Shareholders, he states "One concern that keeps me up at night is that among the 300,000-plus GE employees worldwide, there are a handful who choose to ignore our code of ethics. I would be naïve to assume that a few bad apples don't exist in our midst." And yet as he clearly points out GE spends billions each year to "protect one our most valuable assets - our reputation." Perhaps it is in the recognition of the value of integrity that they earned the honor of being named "The World's Most Respected Company" in a survey conducted by PriceWaterhouseCoopers of 1,000 global CEOs and placed first in integrity.

For those that seek to emulate Jeff Immelt or GE, they would be wise to heed the warning of Adam Hanft of Inc. Magazine. "We are now entering a cycle where ethical accountability will shape the way companies will be judged and valued. This isn't ethics as an ornament, as the accessory of the moment, but as a new systemic force and reality."

Clearly, the real force behind this new reality will be the judgment placed on companies by institutional investors as they make their investment decisions, based in large part, on the perceived value they believe companies place on integrity and the soundness of their organization.

John C. Bogle, founder of The Vanguard Group, points out 100 of the largest managers of pension funds and mutual funds alone now represent the ownership of one-half of all U.S. equities. And the dollar amount held by six of these managers alone is $1.4 trillion. And while thought leaders today like Bogle and Warren Buffett, Chairman of Berkshire-Hathaway, realize the sustainability and success of our capital markets requires two things: long-term returns and long-term investors, one of every ten equity funds turned its portfolio over at an annual rate of more than 200%, while four of every ten funds at a rate of more than 100%. But who can blame them - there is too much uncertainty today as to the integrity of companies so rather than get stuck holding shares in another Enron, these investors are simply moving their money from one slot machine to another hoping to hit the big payoff without losing too much money. This roulette mentality only serves to exacerbate the "mis-valuation", volatility, and instability of our markets.

As we look at the issues raised in our measure of integrity, we should look at the negative impact excessive executive compensation can have on investor confidence. With the enforcement of shareholder rights by the large institutional investors, excessive executive compensation is now actually considered of negative value in assessing integrity, and companies that partake in the practice of excessive compensation over the interests of shareholder will be penalized as it is considered a key component of corporate governance. As these large institutional investors demonstrated in the case of Disney recently, and American Airlines before that, they feel as though excessive packages are not always deserved and don't necessarily align management's interests with that of the shareholders.

While the issue of executive compensation will be an ongoing debate, excessive packages are indicative of poor board oversight,
as witnessed in the case of Dick Grasso, former chairman of The New York Stock Exchange. When we measure the value of board quality in terms of corporate performance we find, according to a BusinessWeek study, companies with the most highly rated boards averaged 51.7 percent in shareholder returns, while the worst boards dragged their companies down to an average 12.9 percent return over the same period of time.

Focusing on the issue of corporate governance as it correlates to shareholder value, we find companies that score higher in their governance rating, provide greater shareholder returns. In fact, Institutional Shareholder Services which has a Corporate Governance Quotient (CGQ) found the top 10 CGQ rated companies outperformed the bottom 10 rated companies by 18.7% Return on Investment (ROI) and 23.8% Return on Equity (ROE).

Meanwhile, researchers have found that companies that demonstrate weaker shareholder rights earned significantly lower returns, were valued lower, and had poorer operating performance and engaged in greater capital expenditure and takeover activity. In a paper entitled "Corporate Governance and Equity Prices" prepared by economists Paul Gompers, Joy Ishii and Andrew Metrick, they found "a portfolio strategy based on purchasing shares in companies with the strongest investor protections and selling short those firms with the greatest management power earned an abnormal return of 8.5 percent a year."

While corporate governance is important, it is only a small portion of the overall factors that is examined when assessing integrity. In fact, Cap Gemini Ernst & Young Center for Business Innovation, used a Value Creation Index (VCI), based upon publicly available data, found that analysts relied heavily on a broad range of 12 intangible factors. The VCI was used to measure a company's performance on these intangible factors. The result demonstrated that "at least half of a traditional company's value is based on nine of the 12 intangible drivers." A high VCI correlated to a higher market value and a "relatively small" change can produce significant changes in market value.

Meanwhile, the University of Michigan's Business School has perhaps the most interesting data when it comes to the value of integrity. Measuring the performance of companies which are perceived to have higher organizational virtues (such as forgiveness, trust, integrity, optimism and compassion) proved to have a higher level of profits.

The conclusion we can draw from all of this important data is that the criteria upon which investment decisions are made, which may ultimately impact the long-term sustainability of companies, is changing. Perhaps that's why the Dow Jones Sustainability Index which invests in companies that integrate economic, environmental and social issues in their strategies, outperformed the mainstream market in 2003. Or why Italy's STAR exchange, which has strict corporate governance requirements, such as compensation of management and directors must reflect that of a company's performance, outperformed their counterparts on the less restrictive Borsa exchange.

Of course, there will always be companies like Arthur Andersen and Enron, who fail to heed the warnings, believing the power of their brand will sustain them in the face of market forces. And for some, indeed their brand will carry them for a while, like Coca-Cola, which has faced one scandal after another. However, even with a brand as big as Coke, the company is beginning to recognize the value of integrity as its share price today trades at 1996 levels. Meanwhile, Coca-Cola's biggest competitor, with far less market penetration has seen significant shareholder gains over the same eight year period of time.

As investors realize the risk vs. the benefit of investing in companies who don't understand the value of integrity is too great, the likely rise and fall of companies in the future will not be based upon accounting scandals but a company's ability to measure and certify its integrity. ■

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