Ethics and Strategy

How strategy, ethics and fiduciary responsibilities are all connected

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TABLE OF CONTENTS

Ethics and Strategy 1
- Executive Summary 2
- Introduction 3
- Strategists vs. Opportunists 5
- The Importance of Culture 5
- Improving Performance and "Acting On Behalf Of" 5
- Creating Value for Customers 7
- Environmental Measures 8
- When Do Circumstances Trigger Increased Likelihood of Unethical Behavior? 9
- What Can I Do As a Member of the Board of Directors to Prevent Unethical Behavior? 11
- Reporting Strategic Drivers 11
- Multi-Business, Multi-Divisional Corporations 13
- Summary 13
- Table 3: Rating Your Company Ethics 14
  - Author Contact Information 16

Executive Summary

The breadth of equity ownership has increased over the past twenty five years due to the demographic bulge of the Baby Boomers who are reaching their savings years and causing high rates of growth in pension funds (averaging around 13% per year). The increasing indirect ownership of companies via intermediaries such as pension and mutual funds appears to have been a cause of poor governance, inflated executive salaries and unethical behavior.

Holdings of corporate equities in the U.S. (end of period, dollars in billions)

Sector	1950	1970	1990	1995	1999	2000	3Q2001
Private pension funds	$1.1	$67.1	$595.0	$1,289.2	$2,156.9	$2,001.1	$1,591.3
State & local pension funds	0.0	10.1	270.7	678.9	1,343.2	1,335.1	1,100.3
Life insurance companies	2.1	14.6	81.9	315.4	964.5	940.8	820.8
Other insurance companies	2.6	13.2	79.9	134.2	207.9	194.3	169.6
Mutual funds	2.9	39.7	233.2	1,024.9	3,400.0	3,250.8	2,442.0
Closed-end funds	1.6	4.3	16.2	38.2	39.9	35.7	28.4
Bank personal trusts	0.0	87.9	190.1	224.9	338.3	280.0	206.2
Foreign sector	2.9	27.2	243.8	527.6	1,537.8	1,748.3	1,524.4
Households & nonprofit organizations	128.7	572.5	1,806.5	4,182.9	9,342.8	7,487.1	5,471.8
Other	0.8	4.8	25.3	79.5	249.9	293.2	270.4
Total equities outstanding	$142.7	$841.4	$3,542.6	$8,495.7	$19,581.2	$17,566.4	$13,625.2
% of total equity held by U.S. pensions	0.8%	9.2%	24.4%	23.2%	17.9%	19.0%	19.8%
% of total equity held by U.S. institutions	7.2%	28.2%	41.4%	43.6%	43.2%	45.8%	46.7%
Holdings of foreign equity by U.S. residents	1.2	6.6	197.6	776.8	2,026.6	1,787.0	1,368.4

Source: Federal Reserve Board "Flow of Funds" www.federalreserve.gov.

Table 1: Pension and mutual funds own an increasing percentage of corporate US equities and continue to grow, accounting for 37% of equity ownership by 2001. NYSE FactBook 2001.

The article suggests that good strategies are firmly grounded in good ethics. Boards of Directors need to spend more time on the reporting of non-financial issues such a strategic performance drivers, value to customer, quality improvement rates, stakeholder concerns, corporate culture measurement and environmental issues.

The author predicts an evolution in the definition of fiduciary duty, one that drives directors to understand the greater variety of factors that drive risk, opportunity and performance in a publicly listed business. Initial signs of this evolution are the Sarbanes-Oxley Act of 2002 and the new rules from the SEC that will force mutual funds to take a more active role with their portfolio of companies. Recent research suggests that "those [companies] most responsive to shareholders… enjoyed returns 8.5% higher" during the 1990s. (*Source: Economist, Jan.11, 2003, p.61 quoting advance copy of Gompers, Ishii and Metrick, "Corporate Governance and Equity Prices, Quarterly Journal of Economics, February 2003*)

This evolution may lead to changes in decision making criteria by buyers of pension and investment management services. Companies and individuals will with, this new information, have the opportunity of selecting mutual funds with different approaches to

proxy voting, ethical, environmental and strategic reporting by their portfolio companies. The relationship between good strategy and good ethics suggests that the historically small product category of "social investing" may be about to undergo a transformation into a more mainstream product, where opportunities for segmenting the market will affect market shares of mutual and pension fund managers.

Just as interestingly, companies that take an active view of marketing their shares, may seek to attract certain kinds of institutional investors whose implicit approval/involvement will attract additional institutional and individual investors. These lead investors may take on a similar vetting role that parallels the role of a lead investor in a venture capital deal where management involvement tends to be higher.

Introduction

Recent events, historical trends, strategic experience and theory suggest that most boards of directors do not have the skills necessary for monitoring the strategic success of companies. An overly *financially-oriented* control and investment perspective has caused boards to spend insufficient time on issues such as ethics, executive pay, risk management, environmental issues, corporate culture, truth telling, punishment for concealing failure, and reporting of strategic drivers of profitability.

Sidebar

Peter Drucker pointed out in 1976 (in The *Unseen Revolution: How Pension Fund Socialism Came to America*, HarperCollins, 1976) how the increasing importance of pension funds would bring what he provocatively called a "neo-socialist" ownership of capitalist companies.

The consequence of this shift towards widely dispersed ownership, combined with modern financial theory (that suggests owning a portfolio of stocks is optimal) has been to dilute the importance of shareholders in setting strategic and ethical values, and in providing genuine oversight. The focus shifted towards financial outcomes.

Even worse mutual funds and pension funds are obligated to diversify their holdings, reducing their ability to be proactive with their portfolio companies.

As the demographic bulge of the Baby Boomers worked its way into its investing and savings years, the predictable consequence occurred – unconstrained and overpaid CEOs and executive teams. Drucker's historical perspective is, in hindsight, here in 2003, impressive.

The importance of shareholder participation in appointing boards is now a much higher profile issue than it has been in the past. In January of 2003, the SEC put in place requirements for professional funds managers such as mutual fund managers to report on their proxy voting.

This greater transparency of voting will, it is hoped, place more pressure on professional fund managers to become more involved in activist management of their portfolio. Failure to do so may represent a failure to fulfill their fiduciary obligations to the mutual fund purchasers.

As a result, many mutual funds must now make explicit policies, procedures and judgments about what will maximize their portfolio return. Very few have been as activist as, for example, CalPERS, the second largest pension fund in the world for the state employees of the state of California. It has an explicit policy on governance at its investment companies and maintains a database on proxy voting decisions available to its pension holders.

In the same period, the Conference Board report on governance suggests that a longer term view of performance needs to be taken by directors:

> "Investor trust in our corporate system is premised on a series of relationships among shareowners, boards of directors and management. Shareowners invest their assets in corporations managed by professionals. This separation of owners from managers is an important feature of the modern public corporation. A key role of the board of directors is to provide oversight to ensure that management acts in the best long-term interests of the corporation and thus in the best long-term interests of its shareowners.
>
> A view toward the long term serves the best interests not only of the company's shareowners, but also of the company's other constituencies, such as employees, customers, suppliers and communities. We recognize the challenge executives face in meeting short-term goals for some constituencies while at the same time achieving the company's long-term goals. However, we firmly believe that managing the corporation for continued long-term viability as a productive organization on behalf of its shareowners can be generally beneficial for other stakeholders."

The Conference Board: "Commission on Public Trust and Private Enterprise: Findings and Recommendations, Part 2: Corporate Governance; Part 3: Audit and Accounting", January 8, 2003, page 3.

The result of these trends is that investors and directors need to explicitly consider the longer term strategic consequences to their decision making and governance approach. This article is an attempt to tie together the key lessons of strategy with some of the micro and macro implications of new approaches to governance – ones that put customers first, take a longer term perspective on customer relationships, and deal with some of the softer areas of leadership by boards. This article will also briefly range over the societal consequences of having a more ethical and long term approach to strategy.

Strategists vs. Opportunists

Corporate decision making sometimes seems like a continuous internecine battle being waged between the "**Strategists**" who take the customer-focused strategic and longer term perspective and those who are "**Opportunists"**.

The **Opportunists** measure their choices primarily in terms of immediate gains or losses to the balance sheet. But as a result of their narrow focus, they frequently make choices that are detrimental to shareholder value and customer loyalty in the long run, and as a result their opportunism may be challengeable on ethical grounds.

The ethical challenge in companies is often triggered by financial problems. When financial problems occur, it is tempting to do business with people you might not normally choose to do business with or in ways that you might not normally use. It is very hard to consider ethical issues when a company is in trouble.

So, as a general rule, the best approach to avoiding temptation is try and make sure that a "strategic approach" to a company involves achieving early and fast success. Small wins not only provide feedback to guide a company, but also reinforce the strategic perspective in a company.

A good strategist not only has a long term view of the business, but also a short term view built around minimizing capital requirements. Marketing – building what customers value – is key to business success. And the faster you learn what customers value, the less trouble you will be in, a lesson often lost on technology companies.

The Importance of Culture

Over the years practically every bank I have observed seemed to end up with employee fraud. As an industry banks seem to make money by setting up fees that customers never expected to pay for and ended up always incurring -- a little like renting a video and having to pay late fees. As customer, I have rarely felt that financial institutions were on my side, acting on my behalf. The culture, and the strategy in a sense, encouraged the values that led to fraud.

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Improving Performance and "Acting On Behalf Of"

At first glance, "creating services on behalf of customers" may appear to be a small issue, but it is, at heart, the antithesis of everything bad that we have seen in the past year. You can't create services well on behalf of your customers if you are overpaying your CEO, misrepresenting your earnings, over-charging your customers. And your capital investment decisions look a whole lot different if you are putting your customers first.

In the CEO role, I have always found that when you are faced with a difficult decision, if you ask: "What would I want us to do if I were the customer?" answers to difficult questions become far simpler.

However, not only are their ethical and unethical *suppliers*, there are ethical and unethical *customers*. So when we ask the question: "What would a customer want us to do?" the assumption is that the customer is an ethical customer that has a reasonable expectation that the company should be fairly rewarded for its activities.

Table 2. It takes two to tango.

	Ethical Customer	**Unethical Customer**
Ethical Company	Baxter Healthcare, Johnson and Johnson withdrawing problem products	Frivolous product malpractice suits
Unethical Company	Enron overcharges California utilities	Andersen provides audit services to Enron

While the full legal fallout from the Enron debacle has not yet occurred and the illegality of activities by Andersen and Enron is still being tried, my guess is that most people would agree with the above table from an ethical perspective. What I find interesting about the table is that, the *companies who have behaved ethically, have gained commercially*. The Tylenol poisoning and J&J's subsequent withdrawal of the product from the market has caused an increase in value for J&J.

And Baxter's recent rapid acknowledgement of a fatal product problem with a medical intravenous product has also garnered it favorable publicity. Interestingly, both companies place high value on their overall corporate or umbrella brand. They realized that it was not only ethically correct to acknowledge and correct the problem quickly, but the financial ,strategic, marketing and ethical) consequences were likely to be very high from prevarication and denial. In these cases, informed self interest should encourage a large organization to do the right thing.

Which leads to the interesting question: J&J and Baxter demonstrate that good ethics is good business, so why do people *not* behave ethically? Why would a company like Andersen handle the Enron affair so badly?

Some would suggest that *an ethical decision is one that costs you something*; so trading off short term losses for longer term gain is not really a hard ethical decision; rather, it is a sound pragmatic decision, particularly if you are highly profitable. But this view relies on the benefit of hindsight. It is much harder to recognize an ethical decision when you are *in crisis*. It is certainly harder to deal with when you are in financial trouble or have set unrealistic expectations about financial growth with financial analysts and mutual and pension funds.

A final observation on the table is that the situation where you have an apparently ethically challenged supplier e.g. Andersen combined with an ethically challenged customer, Enron, seems to be the most dangerous. Here the collusion between two parties extends the period and extent of malfeasance. *This example suggests very strongly that Boards of Directors need to monitor implicit relationships with suppliers and customers as well as explicit relationships.* It also argues for increased separation between the

management of the firm and the Board. In fact, one could argue that the internal audit and external financial reporting functions should have a separate chain of command to the board.

The inflated earnings of many companies in the US leads to another factor in ethical lapses: the reliance upon lawyers and accountants. The higher the complexity of regulation, the more scope and perceived need for seeking professional advice. Accountants and to an even greater degree, lawyers tend to work in shades of grey, dealing with compliance rather than ethics. And given sufficient regulatory, professional and legal complexity, managers can be overwhelmed. While the Sarbanes-Oxley Act of 2002 (the requirement that CEOs certify their results) has restored some balance to public financial reporting, the overwhelming culture of big business in the US remains – in the view of the cynical – that being big means having good legal advice so you don't go to jail for white collar crime. The insistence upon legal as opposed to ethical solutions can seriously challenge even the most well-meaning of CEOs.

And perhaps more importantly, financial performance – the focus of Sarbanes-Oxley -- is not a good measure of increasing or decreasing capabilities, or sustainable competitive position.

Creating Value for Customers

If increasing capabilities, developing a sustainable competitive position, and creating value for customers represent the core of a high achieving an ethical business, what does strategic experience and theory suggest to us?

1. The single largest predictor of new product success is offering a differentiated high value product or service. When you compared the top 20% of high value products with the bottom 20% or me-too products, the success rate is 5X higher for the high value products in a sample of 3,000 new products. And the market shares achieved are also 5X higher for the high value products. So in simple terms, on average, offering a superior product has a 25X higher economic return than offering a "me-too" undifferentiated product. If ethics is about offering value to customers, then directors need to be focused on key measures such as measuring value to buyers to fulfill their fiduciary obligations. (Cooper, Robert: Winning at New Products, Perseus, 1993 and later works)

2. A second piece of confirmatory evidence comes from the Strategic Planning Institute's Profit Impact of Market Share (PIMS) database. Its conclusions are that *high market share* and *high quality* tend to go together. Now while there are some debates about whether (1) high market share drives high quality or (2) high quality drives high market share, it is not surprising that in a well functioning capitalist economy, better products drive out worse products.

3. Another theme that emerges from good strategies is the importance of *relationship profitability*. Customer loyalty leads to repeat purchase. Repeat

> purchase is more profitable because less money needs to be spent on marketing and sales. And, I suppose you could argue that the less money that needs to be spent on marketing and sales, *the more that the customer is paying for the actual cost of the product rather than non-value-adding marketing and sales activities.*
>
> That is not to say that marketing and sales activities can't create value, but as Dell Computer's success demonstrates, many customers do not want to pay for, e.g., sales activities (i.e. via a retailer) if they add little value in a commodity purchase
>
> So a company with high repeat purchase is, in effect, offering a better valued product its customers. Companies like Walmart have built successful market positions through small incremental cost advantages, *but the ability to have a lower level of marketing and sales expenditures can, in some circumstances, have as much impact as a logistical cost advantage.*

Now clearly, there are other sources of cost advantage – scale, scope, focus, learning/experience curves, capacity utilization, time – but the outcome of lower sales and marketing costs is one not frequently mentioned in the strategic literature. A Strategic Planning Institute's PIMS database set of figures quoted in Buzzell and Gale, *The PIMS Principles*, suggests that the market share leader in a market (presumably the supplier with the highest repeat purchase on average) typically spends less on marketing than smaller competitors (8.9% of sales for the market share leader vs. 9.5% for the next two players in the market). So, ethical behavior that leads to high repeat purchase will in fact support the objective of maximizing shareholder value, a fiduciary obligation for a board of directors.

There may well be businesses where repeat purchase is not as important: but even for these companies, behaving ethically and providing superb value to a one-time purchaser is likely not only to be satisfying to employees, but is likely to generate good word of mouth. And in a world where information about quality of service is increasingly available on the Internet, the opportunities for poor quality are likely to diminish. In other words, even in "tourist traps", good ethics can be good business. And if you don't deliver, Zagat Guide is "going to get you".

So, directors need to make sure that they are being informed regularly on issues such as customer value, repeat purchase rate, and marketing measures. When there is a 25X difference between high value and low value products, not paying attention to such measures is a failure in fiduciary role.

Environmental Measures

Many directors and investors are not paying enough attention to environmental performance. And as increasingly important influencers in society and the economy, their attention has long term consequences for society, individuals and the company they supervise. A well reasoned article by Goodman, Kron and Little, *The Environmental*

Fiducary (www.rosefdn.org) makes the argument that not reporting environmental performance has consequences for

1. Financial performance.
2. Management of risk.
3. Fiduciary obligations.

In many industries different approaches to managing environmental performance place companies in different competitive position both with respect to rate of innovation (and creation of new revenue streams) and downstream costs and risk management. They also point out that some legislation requires fiduciary consideration of material environmental risk because such factors can affect shareholder value. One example has been the differing trends in automobile strategy, where the Japanese have taken an early lead with hybrid cars over American firms, pursuing an incremental innovation strategy. In contrast US firms have invested in gas guzzling SUVs and trucks, which are unlikely to represent longer term engine technologies.

Directors and investors, therefore, need to demand reporting of the environmental consequences of businesses. And in a world where special interest activist groups can spring up easily through the Internet, multinational corporations who pursue a sound environmental policy even in less regulated Third World countries can use their reporting to encourage customers to make ethical purchases rather than buying from less ecologically sensitive competitors. Again, good behavior can become part of a brand value as companies such as the Body Shop have demonstrated.

When Do Circumstances Trigger Increased Likelihood of Unethical Behavior?

Determining and delivering value to a customer lies at the heart of strategy. And not so coincidentally it seems also to underlie ethics. Strategy, ethics and economics argue for companies that take a longer view of their customers and relationships.

So under what circumstances does it make economic sense (though not ethical sense) for managers to behave in ways that are short term and damage the future?

There are perhaps seven basic situations:

1. **One-time product.** The product sold is a one time sale and the life cycle of the product is such that it will be sold to many people before word of mouth kills the product. An example of this might be a bad movie which is opened on many screens in a period with few other movies opening. “Tourist traps” e.g. restaurants in tourist trafficked locations are another example. There is always another new customer coming along. One could argue that when the stock market is high, the issuing of an IPO is very similar to the sale of a one time product.
2. **Durable goods.** The quality of the product is poor, but does not show up for some time. During the period of adequate performance, people continue to buy. This

tends to be an issue with durable products like consumer electronics, equipment, housing, etc.

3. **Misleading financial performance.** A company that produces apparent financial growth, but the strategic position of the firm deteriorates over time. In this situation, the financial measurements and more relevant measures such as product quality, customer satisfaction, repeat purchase, and relative product quality improvement are not reported to or understood by investors. This situation can occur in many industries and situations.
4. **Financial engineering.** Companies that focus upon financial engineering of their performance and end up concealing their actual performance through acquisitions and misleading accounting. Enron and Tyco appear to be an example of this situation.
5. **Inappropriate incentives and controls.** Situations where the management is rewarded for behavior that is unlinked to their efforts or actual strategic performance. Many CEOs have reaped vast rewards from being lucky enough to being vested in a bull market. And major studies by Fortune and Business Week have identified many in this category.
6. **Hubris.** Perhaps the most remarkable examples of unethical behavior are the situations where the senior management team is making remarkably high amounts of money and they go even further into excess. Adelphia and Tyco, appear, to many, to fall into this category. By most people's standards, the senior executives involved in these cases seem to have been exceptionally well paid, and yet they crossed a line that seems to defy rationale explanation. Hubris is the only explanation.
7. **Ignorance of consequences.** In a rapidly changing technology driven world, a new class of ethical misbehaviors has emerged. They are informational. While we have always had professional ethics in modern professions – doctors can't disclose medical information; lawyers have a privileged relationship with their clients – we now have a new environment where the consumer's ownership of information about him- or herself has not been well established.

   And if you don't think this is a concern, consider the issues *of identity theft, genetic profiling, erroneous credit reports, terrorism tracking, bio-incident tracking, infectious disease reporting* as hot topics in this area. For many of these issues, there are no simple answers. Who can suggest that someone with an infectious disease that kills people on contact should have exactly the same legal rights as a healthy person? And it is pretty hard to argue against tracking terrorists whose objective is to kill a million people.

   But ethical lines do no need to be drawn – some of the debates about tracking AIDS infections demonstrate the complexity of this informational area. If you force people to register as HIV infected, then perhaps they will not get tested. If you permit anonymous testing, you have more opportunities to intervene through non-profit marketing techniques to change their behavior.

Any senior executive on a boards, who is out of touch with current information technology, may not be as useful as technologically adept younger executives in spotting and assessing these rapidly emerging issues.

What Can I Do As a Member of the Board of Directors to Prevent Unethical Behavior?

The practical question, if you are on the Board of Directors of a company or a member of senior management is, "What can I do to prevent unethical behavior?" The answer is not a simple one. It revolves, I think, into at least ten key areas:

1. Leadership.
2. Independence.
3. Measurement and in particular expanding the importance of non-financial measures of strategic drivers of profitability.
4. A long term perspective.
5. Communicating the softer aspects of strategy, i.e. values and culture.
6. Permitting and rewarding multiple points of views within the organization, which is to say, establishing that the organization is a "truth based" organization where facts, truths, values and measurement matter. In such an organization, facts are prized and consensus is not a tool for concealing facts.
7. Punishing those who conceal the truth within the organization.
8. Reviewing on a regular basis emerging ethical issues such as privacy, genetic screening, etc.
9. Appointing individuals with a strategic and performance measurement expertise in the board.
10. Improving upon the currently unsatisfactory protections for whistle blowers, e.g. providing tenure to whistle blowers, who in spite of legislative protection, seem often to be fired.

Traditionally, the people who have been hired for Boards of Directors have been hired primarily for their demonstration of leadership within their own organizations. Independence has not been hugely prized on most boards, as is evidenced by the tendency to appoint friends of CEOs, suppliers and customers to boards.

But where most Boards seem to fall down is in the area of expertise in strategy and measurement processes. The fundamental fact is that it is almost impossible to tell the real performance of a company from its financial data solely. Yes, financial data can reveal problems, but it is typically inadequate.

Reporting Strategic Drivers

Research by PriceWaterhouseCoopers (now IBM) suggests that public companies that disclose their key strategic drivers of profits are valued more highly by the stock market. The theory is that greater transparency reduces the risk premium on stocks, an important issue in world of doubting investors. So, given that an important objective of boards is to

maximize shareholder value, it seems to me important that boards demand reporting of strategic drivers. (Eccles, Robert; Herz, Robert; Keegan, Mary; and Phillips, David: The Value Reporting Revolution.Moving Beyond the Earnings Games, Wiley, 2000). For those unfamiliar with their ideas, examples of strategic drivers might include:

- repeat purchase in a consumer packaged goods company for key product
- customer relationship profitability in a financial services organization
- percentage of profitable clients in a credit union
- life cycle profitability and custom acquisition cost in a direct response business
- shopping basket completion rate in an e-commerce site
- customer satisfaction measures
- employee retention measures
- patents filed
- new license revenues vs. maintenance revenues in a software business
- average revenues per shopping cart in a supermarket or discount store
- inventory-turn rates in a retail outlet or distribution business.

A key role for board members and investors in the company is to ask about and encourage a longer term view of the value of the business. As everyone accepts, quarter to quarter results are generally pretty meaningless. Managing for quarterly results and failing to meet them can signal problems. But short term financial results do not measure long term continual improvement in capabilities. And few boards report on non-financial measures such as capabilities, or stakeholder issues, let alone commission audits of such performance measures on a routine basis. To some extent, board training can help in this area, but the reality is that strategic assessment and performance measurement is a skill that Boards should include in the same way that the SEC now demands a "financial expert" on the audit committee.

Addressing the issues of financial engineering and misrepresentation is where most of the current reforms have focused, but I think it is equally as important that a company have a culture of "fact based disputes and management". Without such culture, the right questions are not being asked, and just as importantly, experiments are not being undertaken to test uncertainties in the business.

Finally, it seems important that those who conceal the truth about a business should be punished for concealment. Failure can be a major method of learning in organizations, but not when organizations deny that failure has occurred. Boards of Directors should demand value for failure. What have we learned? What are we going to do differently in the future? Whom have we rewarded for failing and learning?

When failures are reported by whistleblowers, the whistleblowers are often punished or fired, in spite of legislation mandating the contrary. I recommend that whistleblowers be given tenure. It is a small price to pay for encouraging early intervention and avoiding the civil litigation and SEC fines from non-compliance.

Multi-Business, Multi-Divisional Corporations

Over the past few decades, most large publicly traded companies have increased the complexity of their business. Some will argue that it is beyond the ability of directors to evaluate the complexity of multiple business units. The strategic issues are so varied and the time required to understand and monitor the business units would be so exhausting that it would be impossible for most current directors.

There are I suspect, three responses to this criticism:

1. Financial and strategic theory suggests that the diversification of many companies is not a reliable source of competitive advantage. So there may as a result, be more pressures for businesses to spin off divisions where synergy does not exist.
2. There will be more pressure to appoint professional directors whose involvement in governance is at a higher level than today's directors. The notion of professional directors may make more sense.
3. For extremely large companies, it is not unreasonable to think about having multiple boards of directors to managed strategically different business units. If a smaller Fortune 500 company doing a billion dollars in sales must have a board of directors, why should a larger conglomerate doing $25 billion in revenues not have multiple boards of directors?

If we accept that directors need to be more involved and that size and business heterogeneity make governance less effective, then companies need more and improved governance.

If our objective is to improve governance, either the complexity must be reduced or more governance capabilities need to be applied in the form of more directorial time or more boards. It would not be unreasonable, for example, to have a different board for managing GE's financial services business than for their engine business. In the past few years, GE's tremendous success allowed a lower level of financial disclosure on a rapidly growing and highly profitable part of its business. If the business unit had had a separate public board, disclosure would have been far higher earlier.

Summary

Directors of companies are faced with a more complex world today. The ownership of equities in society, have, as Drucker predicted, become more dispersed. Directors and boards will be held to higher levels of accountability due to changes in the fiduciary responsibilities of hitherto relative passive investors such as mutual funds. Society seems finally to be recognizing the reduced governance capability of a large group of dispersed shareholders who hold their investments indirectly through mutual and pension funds; a reasonable prediction will be for greater pressure to provide more transparency in strategic, performance, financial and environmental reporting.

Improvements to financial reporting such as the Sarbanes-Oxley of 2002 are not enough. Directors must focus upon corporate culture and the development of new reporting

measures in order to fulfill the supervisory role of the Board of Directors. And the composition of boards will have to change to include a more strategic and long term perspective on the company's performance and strategic performance drivers.

Table 3: Rating Your Company Ethics

1.	The CEO has visibly signaled to the entire company the importance of behaving ethically. He has made decisions that have cost the company dollars, but which have been ethically based.	1 2 3 4 5
2.	The CEO and senior management team is paid fairly relative to the compensation of the rest of the company, say in the range of no more than 20X the average employee.	1 2 3 4 5
3.	The company's culture permits honest debate and encourages truth telling. Employees and suppliers such as audit firms have easy access to more than one individual to report unethical or illegal behavior	1 2 3 4 5
4.	The company's culture, policies and actions demonstrate the company's commitment to punishment for concealment of negative information.	1 2 3 4 5
5.	Managers are promoted primarily on the basis of performance, knowledge and skills.	1 2 3 4 5
6.	The company understands and accurately reports the 20% of strategic cost drivers that account for 80% of company performance in all major business units.	1 2 3 4 5
7.	The company understands and accurately reports the strategic drivers that account for the next ten percent of business unit performance.	1 2 3 4 5
8.	Employee satisfaction is regularly monitored and is high.	1 2 3 4 5
9.	Customer satisfaction is regularly monitored and is high.	1 2 3 4 5
10.	Product performance is regularly evaluated and compared against competitor products. Performance is at the high end of the range.	1 2 3 4 5
11.	Process performance is regularly evaluated and benchmarked. Performance is at the high end of the range.	1 2 3 4 5
12.	Innovation is encouraged formally and informally in the organization.	1 2 3 4 5
13.	The company is managed in such a way as to create a healthy work and family environment. Diversity is accepted as a strength.	1 2 3 4 5
14.	Employees receive training and development and	1 2 3 4 5

	regular feedback. The company treats employees as assets and avoids using part time workers as second class employees.	
15.	The company formally reports on it ecological impact – inputs, outputs, balance sheet. It views environment innovation as a source of strength that creates long term opportunities.	1 2 3 4 5
16.	The company clearly communicates the importance of employee and customer safety. It sets appropriate polices, communicates its values and acts accordingly.	1 2 3 4 5
17.	The company takes a long term view of its customer relationships. It does not transfer inappropriate costs to consumers.	1 2 3 4 5
18.	The company contributes to its communities and pays attention to the general stakeholder needs and concerns.	1 2 3 4 5
19.	The company provides a fair return to its investors over the medium term.	1 2 3 4 5
20.	The company does not change its risk profile with respect to any of its stakeholders without communicating such changes clearly and on a timely basis.	1 2 3 4 5
	Total score out of 100	

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