



# Ethics and the Evolution of Corporate Governance

**By H. Stephen Grace, Jr.**

To borrow the words of Thomas Paine, these are “times that try men’s souls.” The number of large-scale corporate collapses has been startling; and while we thought they were confined to this country, they have now spread well beyond our borders.

These collapses actually provide a valuable framework for the issue I address here: the role of ethics in the evolution of corporate governance. Make no mistake, ethics are important. Ethics lie at the core of personal governance, political governance, and corporate governance. However, and this is the first take-away I want to leave with you, *ethics alone will not ensure effective corporate governance*. Emphasizing ethics, ethical behavior and the “tone at the top,” will not ensure effective corporate governance. We can see this by examining each of those respective areas—personal governance, political governance, and corporate governance.

We observe personal governance in action every day. To guide us in our personal governance, we are fortunate to have over 5000 years of wonderful spiritual and philosophical guidance. However, what we know to be true is that breakdowns in human behavior have continued.

## Personal Governance

Let us just take a moment to look at some of the personal governance guidance we have been provided over multiple millennia; we begin over 2300 years ago with Aristotle. In his work *Politics*, Book 2, Chapter 5, he wrote: “There is the greatest pleasure in doing a kindness or service to friends or guests or compan-

ions, which can only be rendered when a man has private property.” Here is Aristotle talking about man’s greatest pleasures—giving himself and his possessions to others.

We go back, perhaps as many as 1000 years before Aristotle, and far to the East, as the Tao Te Ching stated: “The master has no possessions. The more he does for others, the happier he is. The more he gives to others, the wealthier he is.” Again, there is the emphasis on doing for others and giving to others.

We come forward to the late 18th century when the philosopher Emmanuel Kant set out this powerful quote, finding a moral law within all of us:

Two things fill the mind with ever new and interesting admiration and awe: the starry heavens above and the moral law within.... I see them before me and connect them directly with the consciousness of my existence.

Then we move to Carl Jung in the early part of the 20th century, and his often quoted statement, pointing out the consequences of failing to follow that moral law within us.

Among all patients in the second half of life ... that is to say over 35 ... it is safe to say that every one of them fell ill because he had lost that which the living religions of every age have given to their followers, and none of them has been really healed who did not regain his religious outlook.

And, then only a few years ago—Mother Teresa’s *Simple Path*. In particular, note the last two steps: “The fruit of Silence is Prayer; the fruit of Prayer is Faith; the fruit of Faith is Love; the fruit of Love is Service; the fruit of Service is Peace.” Those who knew Mother Teresa talk about the air of peace around her, in spite of the fact that she was involved with work of extreme difficulty.

So we have had thousands of years of tremendous guidance regarding how we should conduct our personal lives, and yet, we know

**Director Summary:** The chair of Financial Executives International traces the development of governance from personal, through political, to corporate, and concludes that ethics is not enough: a healthy system of checks and balances is needed.



## Democracy is onerous, it is time consuming, but it works better than any form of government thus far.

there continue to be breakdowns in human behavior. Over 2000 years ago, the Latin poet Ovid put it quite well when he wrote, “The better things of life I see and approve; the worse things of life I follow.”

Rabbi Samuel Karff, an outstanding spiritual leader, recently pointed out to me “human nature’s capacity for noble deeds and disgraceful acts.”

Both Ovid and Rabbi Karff capture what all of us know to be true—that we often see the better things of life, the right road to be traveled, and yet we allow ourselves to be lured away from this desirable path. Likewise, we know so well human nature’s simultaneous capacities for noble deeds and disgraceful acts. To restate the first take-away: we cannot simply rely on ethical codes and moral persuasion to carry the day.

### Political Governance

This point is further reinforced by revisiting the lessons of history regarding political governance. For the most part, the history of political governance is a history of kings, monarchs, and dictators. This is not surprising, because conceptually these represent the potentially most effective, efficient forms of political governance. Yet throughout history, structural stresses and troublesome issues continually arose. The basic problem? A consistent failure in “the tone at the top.” Lord Acton captured this problem quite well with words familiar to all of us, “Power tends to corrupt and absolute power corrupts absolutely.”

The search for an effective political governance structure continued. Then, approximately 11 score and seven years ago, 55 men signed a document stating, “We hold these truths to be self evident ...” and democracy was born. Certainly, democracy is a continuing experiment, subject to ongoing examination. To paraphrase Churchill, democracy is onerous, it is time consuming, but it works better than any form of government thus far. At its heart, democracy is an effective set of checks and balances. It emphasizes ethical behavior; it emphasizes the importance of the tone at the top, but it counts on rigorous and robust checks and balances to protect the rights of the governed.

Our revisiting of the lessons learned from thousands of years of personal governance and thousands of years

of political governance makes clear that simply focusing on improving the “tone at the top” is a seriously deficient approach to improving corporate governance. Focusing only on the standards set by company leadership reflects a lack of understanding of human behavior and overlooks the lessons of political history.

### And Now, Corporate Governance

We come now to our second take-away: *a robust set of checks and balances among the participants is critical for successful corporate governance.* Corporate governance is not a zero-sum game. It is not about shifting power from one participant to another. Effective corporate governance involves the dynamic definition of the roles and responsibilities of each and every participant in a transparent manner that optimizes potential synergies. Very simply, good corporate governance leads to a bigger pie, more to be shared by all participants. Poor governance results in exactly the opposite.

Our fundamental belief is that corporate governance is either a win-win or a lose-lose. Not just for the participants, but for all of society. Let us look at what is involved in building the checks and balances framework.

But before I do that, the third take-away: *successful business governance models do exist.* They are alive and well. Let no one think that the area of corporate governance is so complex that it is in fact an unachievable goal. General partnerships, for example—situations where all of the partners are general partners, with a managing general partner, have proven to be highly successful from a governance standpoint. Each of the general partners bears the full responsibility for the partnership—in other words, unlimited liability, at least from a conceptual standpoint.

When I was chief financial officer of Century Development Corporation, I had the good fortune of being involved with two general partnerships. Century was the managing general partner in each, and our partners in the first were Equitable and Northwestern Mutual. Our partners in the second were Metropolitan Life and American General (now part of AIG). What a fortuitous experience for me to be there, serving as the CFO of the managing general partner and having the experience of living with these business governance structures.

The leadership characteristics of the individuals representing the respective general partners were right on target. The individuals were informed: they understood the business of the general partnership. They were involved: major decisions required 100 percent consensus among the general partners. And they believed in service: they were not hampered by an “attitude of entitlement.”

They understood their responsibilities, they were accountable in addressing those responsibilities, and—



very importantly—they were accountable back to their general partner. None of them, in any way, were beholden to Century Corporation, the managing general partner; rather, they were accountable to the general partner they represented.

Another effective business governance model is the holding company structure. Here we have individuals who are exercising oversight over the various subsidiaries. These individuals are also informed, involved, and bring an attitude of service to the performance of their responsibilities.

### Boards as Governance Models

Corporate boards, as the ultimate representative of the owners, must possess the same leadership characteristics. Board members must understand their responsibilities and be accountable in addressing them. They must bring an attitude of service to the performance of these responsibilities, and nowhere should there be any form of an “attitude of entitlement.” Board operations must be driven by directors who are informed, involved, and—to the extent appropriate—have “skin in the game.” A number of board committees significantly affect the corporation’s governance, particularly the nominating/governance committee, the audit committee, and the compensation committee.

Boards of directors today must focus on more than CEO succession planning; they have a responsibility to understand, approve, and monitor the business strategy and operations.

Management personnel must be ethical in the performance of their duties, and they must focus on shareholder value. Simultaneously, management must focus on its relationship with the board. Friendship between management and the board is not inappropriate; however, it must be a friendship built on trust and respect that has developed over time.

### Check, Balance, and Measure

At the heart of the checks and balances is the oversight and control system. This system and its subsystems aid both the board and management in addressing their responsibilities. Yet, and this is the fourth and final takeaway: *the board and management must understand and address the challenges of measurement.* The business press is rife with the difficulties of measuring oil reserves, for example. And perhaps most interesting, in a curious way, is the situation at Smith & Wesson. Its chair, James Minder, a man who has for the past 25-plus years led an exemplary life focused on social work, was found to have served time 50 years ago for armed bank robbery. The problem here was a measurement failure—the proper

## Let no one think that the area of corporate governance is so complex that it is in fact an unachievable goal.

information was not measured. No one was intentionally hiding anything.

These challenges make clear that effective management oversight and effective monitoring of operations by the board requires not only review of the profit and loss and balance sheet, but also tracking of cash flows and key value drivers. Cash flows come not from the funds statement; instead these can be the actual cash receipts and cash disbursements on a unit-by-unit basis. At the same time, management in its own right, and the board in addressing its responsibilities, must understand and oversee the enterprise-wide risk management program in place.

### Toward the Future

As I look toward tomorrow, and where the evolution of corporate governance is headed, I think of a quote recently brought to my attention. St. Thomas Aquinas, many centuries ago, said, “Holiness is nothing else but a resolution made.” Thomas Aquinas was saying that holiness—spiritual excellence, if you prefer—is not genetic. It is simply an individual making a resolution to lead their life in that manner. I believe strongly that the overwhelming majority of members of boards, senior management, and internal and external auditors have made a resolution to live and work ethically. They have integrity; they believe in codes of ethics. Systems of checks and balances encourage and support them.

As the corporate governance evolution continues, we will see effective corporate governance cultures emerge. They will be built on a strong ethical foundation, but not rely on ethics alone. They will incorporate robust checks and balances that address the challenges of measurement, and they will be characterized by transparency. ■

**H. Stephen Grace, Jr., Ph.D.**, is president of H.S. Grace & Co., Inc., and chairman of Financial Executives International (FEI), an organization of 15,000 upper-level financial executives. This article is adapted from the April 30th, 2004, keynote address he delivered at the University of Houston “Bridging the GAAP” conference. He may be reached at [hsgrace@hsgraceco.com](mailto:hsgrace@hsgraceco.com). The views expressed in this article are those of the author and not necessarily those of FEI.