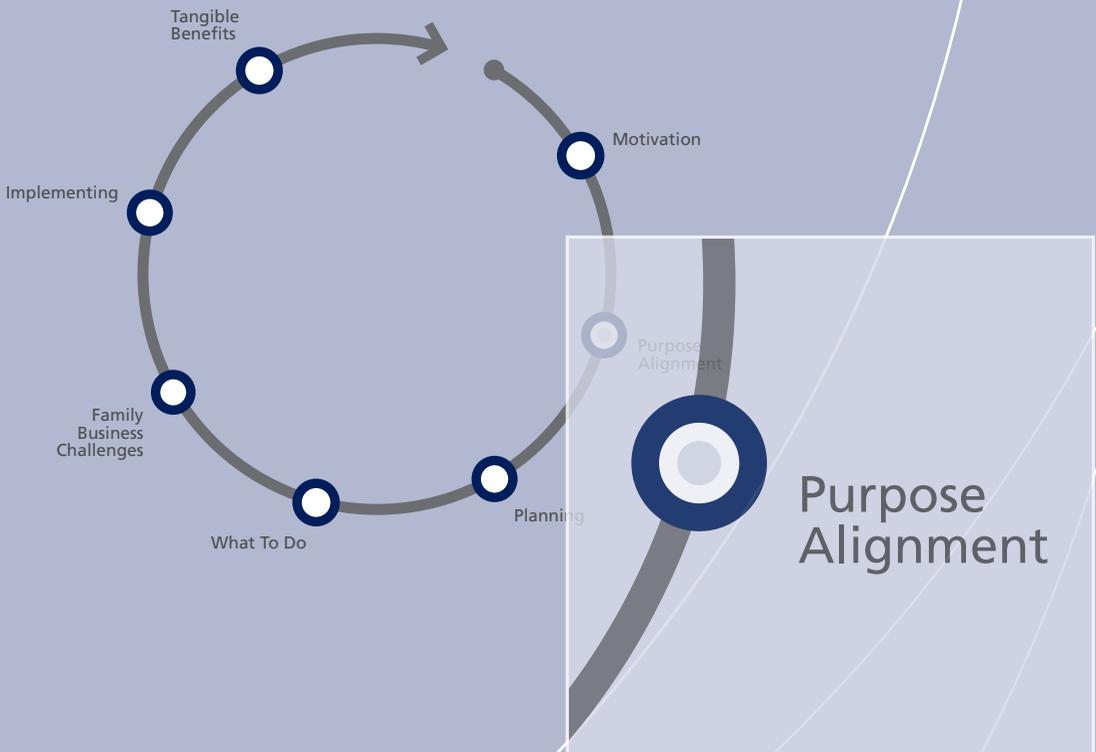


# 2

## PURPOSE ALIGNMENT: CHANGING ATTITUDES AND GENERATING COMMITMENT





## Chapter 2

# Purpose Alignment: Changing Attitudes and Generating Commitment



### KEY MESSAGES

**Gain agreement on a common strategy.** After company leaders identify a shared vision of improvements to the corporate governance framework and practices, take steps to obtain agreement from all company stakeholders on your corporate governance strategy.

**Identify resistance points and clearly communicate goals, approaches and anticipated results.** Governance changes can affect everyone associated with the company, across all levels of the company's hierarchy. Be sure to identify possible resistance to changes and clearly communicate objectives, specific actions and anticipated results so that everyone is on board.

**Make use of internal "champions".** Governance champions can play an important role in addressing existing and potential concerns, changing attitudes and generating commitment to improved governance policies and practices.

Companies may have clear motivation for choosing the path to improving their governance policies and practices. Still, most firms face obstacles in aligning the vision and understanding of all interested parties and changing attitudes to meet the chosen objectives.

This chapter details ways in which company leaders can change attitudes inside their organizations, creating the momentum to pursue a new approach to doing business and leading their companies towards better governance practices. The lead actors in this process of governance transformation are introduced here: the "champions", who persevere and inspire others, ensuring that everyone is working towards a common objective.

Of course, changing attitudes and shaking up entrenched beliefs and practices to lead companies to success requires much more than a state-of-the-art plan. It is also necessary to work on people's will. Good corporate governance is a process, both in terms of defining frameworks and implementing best practices. It requires a change in attitude that needs to be built into the strategy of the business as a whole.

Companies Circle members report that they took risks in the beginning when they made corporate governance changes, because there was no guarantee that the changes would pay off and that good governance would really become a winning strategy. In this chapter, members detail their efforts to change attitudes and beliefs and describe how these efforts paid off, giving them competitive advantages over other firms.

## 1 Agree on the Common Vision; Align Interests

Simply stated: one of the main challenges in kicking off a process of corporate governance improvement is to align interests among all key players involved in governing a business.

The understanding of the need to change is not uniform. Some doubt that the proposed transformation is useful. They may have differing opinions on the best way to go about making changes. Others might resist because of their personal interests.

As a result, the people inside the organization who are driving the initiative will need to devote significant time to creating a common vision that answers these questions:

- › What changes will be implemented?
- › How will the changes be implemented?
- › When will they be implemented?
- › What benefits they will bring to the company?
- › What risks may impede achieving the intended results on time?

This applies to all companies, from relatively small, family-owned businesses to huge organizations with complex ownership structures.

Alignment requires all key players—owners, boards of directors, management, other key stakeholders—to be united from the outset, thus shaping a common interest, a common purpose. These parties often have inherently diverging interests, which makes the agreement over the strategy for governance improvements even more difficult.

How can shareholders ensure that the managers will run the operations of the company in the interests of the owners and not in their personal interests?

### 1.1 Overcoming the Agency Problem: Bringing the Interests of Managers and Owners Together

This question gives rise to a fundamental corporate governance theory discussion. On a practical level, it is a major issue for entrepreneurs as well: the managers are paid to run the business in the best interests of the owners but they may make decisions based on personal interests that differ from those of owners. With owners considered the “principals” in this relationship and managers their “agents,” this divergence of interests can be understood in economic theory as the principal-agent or agency problem.<sup>19</sup>

The agency perspective is useful not only for understanding the divergence of interests between owners and managers in capital markets where ownership is dispersed and companies are typically run by outside hired managers. It is also applicable in the case of Latin American companies, where ownership tends to be concentrated. This perspective offers insight into the relationship between controlling shareholders and minority shareholders.

In such cases, minority shareholders might worry that their rights could be abused by managers aligned with controlling shareholders. Thus, the agency problem in such markets shifts from the relation between owners and managers to the one between minority, non-controlling

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<sup>19</sup> For a better understanding of agency theory, see JENSEN, M., & MECKLING, W. (1976). Theory of the firm: managerial behavior, agency costs and ownership structure. *Journal of Financial Economics*, 3, pp. 305-360. See also the glossary of this guide for a brief explanation of agency theory.

shareholders and controlling shareholders. The controlling shareholders may run the company based on their own interests—which may not always coincide with the interests of other shareholders.

How does this drama play out? Here are some examples of what are known as private benefits of control, which today translate into a price discount if proper processes and oversight mechanisms are not in place to avoid them.

Action	Why It's a Problem
The controlling owner appoints unqualified family members to managerial positions	<ul style="list-style-type: none"> <li>› The owner and family benefit at the expense of other owners</li> <li>› The action puts the business at risk due to the lack of proper leadership</li> </ul>
The controlling owners hire a third party service from a company related to friends or relatives	<ul style="list-style-type: none"> <li>› The action takes into account the friends' or relatives' value creation, and not what is the best option for the company and all shareholders</li> </ul>
Owners who control and manage the company pay excessive compensation to themselves or to their relatives	<ul style="list-style-type: none"> <li>› The action takes value away from the other shareholders</li> </ul>

Clearly, this is an issue for business leaders. The agency problem can drain value and hinder company performance and growth possibilities unless sufficient governance mechanisms are in place to monitor and ensure that all shareholders' interests are respected. Ideally, they should be aligned as well. Understanding these relationships will help company leaders find governance solutions that provide the comfort level needed to attract investors.

One way to align the interests of shareholders and managers is with a well-designed compensation policy that is linked to specific targets. This helps clarify objectives to be pursued. Governance practices that offer transparency and fair treatment to all shareholders can all ensure the alignment of interests of different groups of shareholders. Chapter 4 explores these specific governance practices in greater detail.

## 1.2 Identify Corporate Governance Champions

In general, bringing about changes is easier when the people responsible for their implementation and success are convinced of their value and show strong commitment to them. Every important change needs a person or a group of persons who are committed to seeing it through and who will make sure that it achieves the intended results.

In particular, the need for these internal champions is critical when it comes to corporate governance improvements. Since some improvements may require changes in the company's fundamental principles and standards, it is always good to have support from the highest possible level of leadership.

Best case scenario: when the controlling shareholder, in many cases the founder or the patriarch of the family, is such champion.

In reality, though, the initiative and leadership often comes from the younger generation of the owners. Non-family professional managers also may lead such an effort. Bottom line? Such

leaders are critical to spearheading efforts. They help overcome existing or potential resistance. They dedicate time and resources needed for the success of the transformation. And they rally all interested parties around common goals.

The examples below demonstrate that a change in attitude and broad-based commitment to the principles of good corporate governance can help obtain agreement from all stakeholders—or, at a minimum, can help ensure that there is no resistance in the company’s new purpose and new governance structures and processes.

- › Identifying the leaders was part of **CPFL Energia’s** route to improved governance. The company established the Corporate Governance Support Committee, with a team exclusively dedicated to developing and improving governance at the company. It supported the board’s activities, facilitated the information flow and identified opportunities for improvement.
- › **Ferreyros’** CEO and CFO have been the primary champions of a recent round of governance improvements, proposing changes in the by-laws that would appeal to a broader base of investors and to attract independent directors to sit on its board. They also spearheaded the creation of important documents such as statutes for shareholders meetings and for the board. These documents facilitate corporate governance and ensure that governance is an embedded aspect of the company’s code of conduct—not the pet project of specific individuals.
- › **NET** secured sponsors at both the board and the senior management levels. These sponsors helped drive the changes.

### 1.3 Building a Common Understanding from Top to Bottom

For governance transformation to succeed, all interests must align at all levels of the organization, from top to bottom. The commitment from the top is crucial, because of the key roles that the controlling shareholders, the board of directors and senior managers will need to play to improve the company’s governance.

#### **Governance improvements with generational leadership shift and company reorganization**

At **Suzano**, governance improvements came along with an ownership reorganization initiated in 2001 when David Feffer, the founder’s grandson, took the helm of the company following his father’s death. Among Feffer’s first steps: implementing a new holding company management model. A team of specialized consultants helped with the process, including strategic planning and clearly defining the company’s vision, mission, values and strategic objectives.

The effort extended to subsidiaries **Suzano Papel e Celulose** and **Suzano Petroquímica**, which implemented their own strategic planning sessions, based on parent company guidelines.

The subsidiaries dismissed 80 employees, including some family members who held positions created with the sole purpose of attending to the heirs’ interests. This action reduced overhead costs by 30 percent. It also sent a clear signal to all employees—and to the market—that a real governance transformation was underway, with the goal of prioritizing company interests over the interests of individual family members.

*“Besides increased share liquidity, share appreciation and access to new funding at lower costs, being a capital markets-driven company has the side benefit of having external stakeholders exercising daily pressure for results, issuing appraisals, research reports, among others. Since corporate governance is all about alignment of interests, the introduction of short- and long-term incentive plans linked to value creation and share performance for executives are essential elements of a well-defined governance plan. But the strategic long-term commitment of the controlling shareholders is the essential element of success. Only with such a long-term approach can the status quo of a company be shaken and a change in behavior take place.”*



—**João Pinheiro Batista Nogueira,**  
Suzano, former Co-CEO

### Top management as agents of change

At **Buenaventura**, the board of directors and top management were the leaders who signaled that the company had decided to move seriously towards adopting better governance practices. From the outset, they were committed to making real changes.

Driving this group to think and act in unison: the notion that better corporate governance could create value through better corporate governance.

In the ensuing years, this notion was affirmed as the company’s market value continually increased. The growth made Buenaventura’s leadership even more committed to good corporate governance. The board and senior management took additional steps after they implemented the round of initial changes.

- They defined the vision, mission and values of the company with the support of external consultants.
- They established strategic objectives and an action plan to implement the new structure at all levels in the company.
- They remained aligned and fully committed to the process, communicating the strategy to achieve the company’s corporate governance goals across all quarters of the organization.
- They established a long-term compensation plan for senior management that would help align their interests with the strategy and interests of shareholders, ensuring implementation of this strategy.

*“The members of Natura’s board established strict conditions for preparing for our initial public offer. A series of variables were established to be achieved before implementing the IPO. This in itself already represented an extraordinary commitment, since the decision to go directly to BM&FBOVESPA’s Novo Mercado segment demanded prior preparation by the company. Based on this decision, all members of the board of directors had to become aligned with the governance principles that were being proposed to the company at that time.”*

—David Uba, Natura, former CFO



**Improvements require hands-on involvement.** External advisors or consultants can facilitate the governance reform process, in part due to their objectivity. But complete, hands-off reliance on external consultants to implement a governance initiative could doom the effort to failure.

Here’s why: the implementation of new ideas must be driven by company leaders—shareholders, board members and senior managers. Before putting governance improvement plans into action, these ideas need to be discussed in detail to ensure an internal agreement around common approaches and goals is achieved.

The vision and the plan must be shared with all levels of a company that in one way or another will impact or be impacted by changes. Explicit, firm commitment of managers, directors and main shareholders to the corporate governance project’s goals must be achieved. Showing future project returns to all stakeholders is one of the ways to make their commitment a reality.

### **CPFL Energia builds internal momentum**

For **CPFL Energia**, long-term strategies were defined in an internal consensus-building process and then implemented throughout the group in ways that ensure best practices and respect the company’s culture. Communication was essential. The leadership team, with guidance from its external consultants spread the word by way of clear, simple documentation in print and web formats so that shareholders, employees and investors alike understood what was happening. The firm’s 20-plus subsidiaries—whose leadership is part of the company’s executive team—were also aligned through by-laws amendments and similar management processes. All companies in the group adhere to the same corporate governance rules. By sharing the same governance practices, corporate processes are optimized and decision-making is improved, allowing the companies to focus on their core businesses.

In agreeing to share future benefits across the entire group, CPFL Energia's leadership further cemented commitment to governance improvements throughout the entire organization. Among the steps taken: offering minority shareholders of CPFL Paulista, CPFL Piratininga, CPFL Geração and RGE the option of a share swap of both common and preferred shares for common shares in the holding company, and listing on BM&FBOVESPA's Novo Mercado. These recently acquired companies, with a handful of minority shareholders, will have the same possibility to migrate to the holding company for a fair price.

**Benchmarking builds commitment.** Another way of helping to ensure that all levels of a company share in the understanding of and commitment to corporate governance improvements is to embark on a discussion of benchmarking the company's practices against existing references in the market—codes of best practices and corporate governance guidelines produced by associations, regulators and institutional organizations and the like. For more on benchmarking, please see Chapter 3, Section 2.

*“When we first heard about “corporate governance” in Peru, although the name was quite new, the content of it was fairly known by our company, which had always been managed under values such as fairness, equal treatment and transparency. However we realized certain details in how we managed the company could be improved, specifically in the way the board could add value by bringing new experiences and points of view with more independent directors and having board committees. We also found some articles in our by-laws that made great sense for a company owned by four shareholders more than 70 years ago, but were not relevant in a company owned by almost 1,000 shareholders, some local, some from abroad. We dedicated a lot of time to studying the OECD Principles and then the Peruvian corporate governance code,<sup>20</sup> and brought some ideas to our board, where we always found great openness.”*



—Mariela García de Fabbri, Ferreyros, CEO

<sup>20</sup> OECD, ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (2004). Principles of Corporate Governance. Available at <http://www.oecd.org/DATAOECD/32/18/31557724.pdf>. CENTRO DE ESTUDIOS DE MERCADO DE CAPITAL Y FINANCIERO (2001), Perú: Código de Buen Gobierno Corporativo para Empresas Emisoras de Valores.

## Building a common understanding for corporate governance needs

**Ferreiros'** leaders understood early on that to attract investors and differentiate itself from other companies participating in the capital markets, it was important to constantly adopt changes that ensure transparency, equitable treatment of shareholders and efficiency in its operations.

This on-going commitment to continuous improvement was possible because members of the board and top management have always been clear on the role corporate governance practices play in Ferreyros.

This became even clearer as Peru adopted a new governance code—spearheaded by Ferreyros' leadership—and the company embarked on a new round of improvements, implementing changes in its by-laws to appeal to a broader base of investors and to attract independent directors to sit on its board.

With their total involvement with governance reform, Ferreyros' leaders could demonstrate through their positive results that companies with good corporate governance standards—implemented after first gaining solid top-to-bottom internal commitment—have a strong competitive advantage over other companies that don't understand its importance.

### 1.4 Understanding Sources of Resistance; Taking Actions to Overcome

When looking at sources of resistance, a good place to start is at the highest level—the controlling shareholders. There will be resistance from senior managers and employees as well. At the ownership level, the founders/older generation are, in some cases, the source of resistance because they do not want to change the way the company is run. Some family members may resist the reform because they may lose power or their jobs. Others may want to hold up the process until they are convinced of their potential personal gain.

Senior management's resistance may come because some managers might be close to the controlling family. They also might be afraid of losing their jobs. Others might see danger, because more qualified people could be brought into the company or because there could be required more accountability. A third group might resist simply because it lacks a clear understanding of the changes.

And then there are the employees. Workers at all levels can be a major obstacle to the successful implementation of corporate governance improvements. Typically, this resistance is due to:

- › Lack of awareness about the changes and the value the changes can bring
- › Discomfort with the ways things are being done or how changes will affect the way they do their jobs
- › Fear of losing their jobs
- › Concern about an overload of additional responsibilities

The team implementing governance improvements will need a strategy to overcome—or, at the very least, to minimize—resistance and to align goals.



## For Your Consideration

If your company has a history of confrontational relationships between employees and key executives, consider organizing collaborative teams that include workers and these same executives. This will help uncover the underlying reasons for hesitation and reduce the cultural resistance to change.

Companies Circle Members Tackle Resistance	
Problem	Solution
<b>CPFL Energia</b>	
The implementation of governance improvements such as the development of a succession plan, the introduction of an anonymous and confidential communication channel concerning accounting and other fraud issues, and the automation of controls for the preparation of financial statements have sometimes been met with some measure of resistance, which is natural in change processes.	To deal with this resistance, the changes have been introduced with consistency after discussion with all the stakeholders. Additionally, management's sponsorship and support was helpful.
<b>Buenaventura</b>	
There was some resistance to change and particularly to the process of formalizing the governance policies at the company. Commitment and active participation by the whole organization was expected, principally from top management.	To address this resistance, the formalization of governance policies was done over time of almost a year as part of a permanent improvement process. With the new written policies, employees are now able to speak the same language at all levels of the organization, and the company has increased its efficiency and effectiveness.
<b>NET</b>	
As one of the first companies to enter this process, NET faced the challenge of making an internal case to prove that the company's corporate governance changes were here to stay and that all major companies would soon follow suit. Not everybody had the same vision.	NET embarked on a vigorous benchmarking exercise to make the case that the corporate governance wave was coming and that it would prove positive, creating strong shareholder value if the company could be at the forefront of the process and not a follower. NET's investor relations team met with staff to demonstrate the workings of capital markets and how transparency impacts on company valuation. This process continues to work well for the company as it builds on its corporate governance improvement efforts. When NET began to consider a Level 1 listing on Brazil's special corporate governance exchange segment, the company's investor relations and legal departments worked closely with BM&FBOVESPA, to understand the implications of adhering to Level 1 and in anticipation of a potential Level 2 listing. Staff in these departments knew that many companies had resisted one of the listing requirements—Market Arbitration Panel—and they wanted to be prepared with responses to anticipated resistance. The earlier coordination contributed to the alignment and saved time.*

\* The Market Arbitration Panel (CAM - Câmara de Arbitragem do Mercado) is a forum designed by BM&FBOVESPA to settle corporate disputes outside the official Brazilian judicial system. It provides an agile, cost-effective and independent environment for dispute settlements in line with the directives of the Arbitration Law. Companies listed on BM&FBOVESPA's special listing segments (the Novo Mercado and Levels 1 and 2) must comply with CAM.

**External consultants can ease the resistance and bring people together.** Sensitive issues in a group can seem irreconcilable because the disagreeing individuals may not understand the real reasons behind their disagreements. They may object not because of resistance to change, but because of underlying and unstated attitudes or objectives. In the case of family members or senior managers, resistors may see the company as their main focus in life or they may prefer to spend more time on other activities and delegate the running of the company to others. Such attitudes will inform their approach to governance initiatives.

External consultants can bring shareholders with opposing views together. They can facilitate agreement on a common strategy to create a constructive environment for building consensus. One approach involves individual meetings with company leaders and main shareholders. Such meetings lead to a better understanding of their personal objectives. The meetings also explore ways to overcome personal differences to achieve a shared vision of how the company should be controlled and managed.

## 2 Changing Attitudes

In general, changing attitudes can be a sensitive task. It is even more difficult when the changes concern the ways the company is managed and controlled.

### Building a solid conceptual base for change

**Argos** began to believe in the philosophy and attitude of good corporate governance long before legal norms in Colombia required this. The company's leaders understood that the foundation of governance improvements had to be built over a solid conceptual base. Their first step: creating a strong code of ethics and governance that clearly defined important aspects concerning the company and indicated the expectations for each employee.

Later, the code was amended to conform to international benchmarks. The revised code, which emphasized aspects of disclosure and the free flow of information, was discussed with all internal stakeholders, from the employees to the board of directors. The code discussion process served as a means to align the understanding of future governance changes within the company and mobilize people around them.

### Untimely death propels shift

At **Suzano**, a change in attitude was accelerated by the unexpected death of its chairman Max Feffer. Although he had already started to cultivate a strong team of professional managers and prepare his heirs for eventual transition, his sudden absence made it impossible to postpone decisions concerning the company's new path.

In a single meeting, over the course of one afternoon in April 2003, the family decided to implement a new governance model, making important changes to the role of the controlling shareholders. Feffer's son David invited his brothers and their main advisor, Boris Tabacoff, to a meeting with external executives who were already working on a transition plan. The consultants presented their initial conclusions, the proposed management model and the basic action plan. They identified the consequences of implementation, many of which would be painful to family members. The proposal was fully approved, with family members understanding that the approval would establish a long-term strategic vision. The family decided to step away from the executive function and focus on strategic direction and management oversight. From that time forward, the family adopted a new motto: 'One should not live off the company, but off the company's results.'

## Leadership succession

Yet another example of a change in attitude and strong commitment can be seen at **Ultrapar**, which has a history of corporate governance that dates back to the 1980s. As presented in the previous chapter, Ultrapar's decision to adopt better corporate governance practices was intimately related to the company's management professionalization process and the leadership succession issue. Thus, ensuring continuity and institutionalizing the company to guarantee its long-term success were the main reasons for adopting better governance practices, including a pioneering remuneration system to commit and align executives with the long-term interest of the owners.

Such examples demonstrate that change requires a solid understanding of the goals the companies wanted to achieve. Companies must create opportunities for management, board members and shareholders to interact with other leaders within the firm, listening and learning from each others' experience.

Companies Circle members also underscore the importance of reaching out to experts in their own countries and abroad to obtain the necessary information, references and knowledge. At the time these firms started their journey toward better governance practices, other examples of implementing good practices were still hard to find. This forced shareholders and directors to reach outside their circles to find the guidance they needed, an effort that included business meetings, informal gatherings, business association events, training programs and seminars and conferences.

Now that the main initiatives to align governance actors and generate commitment to change have been addressed, it is time to move on to the details of how to carry out planning.

## For Further Thought and Discussion:

- How would you go about obtaining agreement for governance improvements in your organization?
- Who are your company's key players to include in the process of initiating and implementing governance improvements?
- Make a list of your company's key resistance points. How would you overcome the resistance?
- Create a sample agenda for a meeting that would bring together key executives and employees as a way to find common ground and overcome a history of confrontation.