

REWARDING VIRTUE

**EFFECTIVE BOARD ACTION ON
CORPORATE RESPONSIBILITY**

FULL REPORT

Business in the

Community



HBOS plc



ACKNOWLEDGEMENTS

We would like to thank Lord Stevenson of Coddendam, Sir Derek Higgs and Mark Makepeace, Chief Executive of the FTSE Group for chairing round-table discussions with board directors, and to the various board directors, company secretaries and other executives who took part (see Appendix).

The report benefits from several case studies showing current board practice. We thank BA, BHP Billiton, BT Group, BP, GSK, GUS, HBOS, National Grid, and Westpac for allowing us to describe examples of the approaches to corporate responsibility taken by their boards, and to staff at these companies for helping us to understand how their companies work.

Thanks also to Douglas Brook, Julia Casson, Rachel Crossley, Juliet Davidson, Sir Derek Higgs, Lord Stevenson, Rory Sullivan, Kerry ten Kate, Steve Waygood, and Lorraine Young for commenting on earlier drafts.

This report results from a collaboration between Business in the Community (BITC), FTSE Group and Insight Investment, with the support of consultants, Acona. Caroline Cook and Patrick Mallon (BITC), Jayn Harding and team (FTSE Group), Jaqui Boardman and Simon Hodgson (Acona) took part in the project from the start – opening doors, gathering material for case studies, contributing ideas, challenging arguments, and painstakingly commenting on several drafts. This report is much better as a result.

Craig Mackenzie, November, 2005

A report of a joint inquiry by Insight Investment, Business in the Community and the FTSE Group. Written by Craig Mackenzie with Simon Hodgson.

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Published by
Business in the Community
137 Shepherdess Walk,
London N1 7RQ

The full version of the *Rewarding Virtue* report is available in PDF format for free or order a hard copy for £20 at:
www.bitc.org.uk/resources/publications/rewardingvirtue.html
www.insightinvestment.com/responsibility/rewardingvirtue.asp

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FOREWORDS

Business in the

Community



This report makes a well argued case that the board has a key role to play in delivering responsible corporate behaviour and along the way it deals with some sacred cows – the biggest of which is the idea that business is just about focusing on shareholder value. Corporate responsibility is part and parcel of long-term value creation; this report shows why.

The Combined Code says that boards should set the values and standards of the company, and ensure that it meets its obligations to shareholders and others. This report offers some very useful suggestions about how boards should go about fulfilling this task.

The basic premise – that market failure and other misaligned incentives can drive companies off course – adds some helpful realism to the corporate responsibility debate. But the report breaks new ground in showing how boards can play a decisive role in responding to these unhelpful incentives and so ensure companies behave responsibly.

If companies are to enjoy the long-term rewards associated with a reputation for trustworthy and responsible behaviour, boards must deal with corporate responsibility in their routine agenda items: approving strategy, reviewing risks, managing executive incentives, overseeing internal control, and setting the tone of the business. Boards that treat corporate responsibility as a bolt-on, risk failing to fulfil their obligations to both shareholders and others.

This report is an important departure for Business in the Community – it is the first time we have tried to connect corporate responsibility and the role of the board. I hope the report's recommendations are seen as I see them: a useful addition to thinking about corporate governance.

Sir Derek Higgs

Deputy Chair, Business in the Community

As a leading global index provider, FTSE Group (FTSE) works closely with the world's investors and over recent years we've seen socially responsible investing move from a niche investment style to become a strategy that today forms an important part of the investment landscape.

FTSE first became involved in this arena in response to the growing demand from investors for tools to measure standards of corporate social responsibility. Beginning with the launch of the FTSE4Good Index Series in 2001, we've worked hard to evolve this index into a global standard for both listed companies to benchmark themselves against, and for investors to use as an investment tool. FTSE's in-house engagement programme works directly with listed companies, helping them to understand and meet the criteria for inclusion in the FTSE4Good index.

FTSE also contributes to the debate about corporate responsibility through its ongoing research activities to inform the future development of the FTSE4Good index. We held a public consultation during December 2004 and January 2005 to define investors' priorities for future development. Over 250 respondents from 21 countries, ranging from academia, investors, NGOs and government contributed detailed feedback. Governance of corporate responsibility was seen as one of the major priorities across all respondent groups. The feedback pointed out that although 'traditional' corporate governance has risen to the fore in recent years, many people believe that the same principles of board controls and accountability should be applied to managing corporate responsibility risks and opportunities as well.

FTSE Group is pleased to be involved with Insight Investment and Business in the Community in this research project into the board's role in the governance of corporate responsibility. Through it we hope to help identify and share best practice in the governance of corporate responsibility and explore how the findings could contribute to the future development of international standards.

Mark Makepeace

Chief Executive, FTSE Group



HBOS plc

Insight Investment is one of the UK's largest institutional investors. We manage £84bn on behalf of some 300 pension funds and ultimately for several million individual savers. We have a long-standing commitment to support and encourage company boards in their effort to achieve high standards of corporate governance. This commitment is backed by one of the largest and most experienced corporate engagement teams in the City.

Corporate governance is about providing the entrepreneurial leadership for the business necessary to create shareholder value over the long-term. As this report argues, ensuring corporate responsibility is a fundamental part of achieving this.

Over the last three years Insight's Investor Responsibility team has engaged with over 200 companies on questions of corporate responsibility. We have sought to encourage all the companies we invest in to achieve the standards set by the best, and to encourage the best to reach even higher. Our suggestions have generally been welcomed by the companies concerned and, in many cases, they have been adopted.

We have also worked to improve the way we integrate analysis of corporate responsibility issues in our standard investment decision-making process. Corporate responsibility issues are often strategically significant for companies – particularly over the long-term – and when they are, it is important that we incorporate them into our investment decisions.

We undertake this activity because we believe that corporate responsibility is an essential part of long-term value creation. Our clients, therefore, have a compelling interest in encouraging it. We also accept an obligation to companies and their stakeholders, to play our part as a responsible shareholder. Raising corporate responsibility issues is also a requirement of the Institutional Shareholders Committee statement of principles, which we support.

Through our engagement with companies, it has become clear to us how important board leadership and oversight is to corporate responsibility. Equally, it has become evident that there is a lack of understanding and consensus on the nature of corporate responsibility and on the role of the board. By supporting this report, we hope to contribute greater clarity on these topics.

Douglas Ferrans

Chief Executive, Insight Investment

EXECUTIVE SUMMARY

What should boards do to ensure companies behave responsibly, and why? Both corporate responsibility and corporate governance have climbed the corporate agenda in recent years. But there has been little consideration of how these two areas interrelate or about the specific board contribution to corporate responsibility.

The Combined Code on Corporate Governance makes clear that corporate responsibility is important. It states that “directors should set the values and standards of the company and ensure that it meets its obligations to shareholders and others.” But beyond this high-level guidance, the Code provides little detail. Similarly, the Company Law Review and the recent Company Law Reform White Paper link corporate responsibility to the duties of directors. Directors, it is suggested, should take an ‘enlightened’ approach to value creation by taking into account, where relevant, the interests of other stakeholders, the company’s social impacts and its reputation for integrity. But there is no detail about what this may require of board directors in practice.

Of course, the lack of guidance has not stopped boards developing their own approaches – and this report has benefited from the accumulated wisdom of a number of boards that have grappled with this question. The lack of detailed guidance on this topic prompted Insight Investment to join with Business in the Community and the FTSE Group to undertake a programme of analysis, research and consultation about the board’s contribution to corporate responsibility.

The report focuses on the governance role of boards, rather than the management role of the executive directors – it is about the direction and control of corporate responsibility, not its operational management. In seeking to consider the board’s role, this report has sought to work within the accepted role of boards. We recognise the heavy demands placed on directors of listed companies but suggest that, even though corporate responsibility is often challenging, effective board action need not involve much extra work. The report argues that corporate responsibility is a precondition for sustainable long-term value creation. But many powerful pressures and temptations can drive businesses off course, unless proactive steps are taken to respond to them. Boards have a decisive role to play in doing this, by creating companies where responsible behaviour is second nature. The secret of success is to ensure that – in choosing strategy, approaching regulation, designing incentives, shaping the organisational culture, and overseeing internal control – virtue is rewarded.

The nature of corporate responsibility

Corporate responsibility sets the terms of an implicit contract between companies and society. This contract is a foundation of our free market system and is enormously valuable to all parties. It establishes the shared expectations on which people place their trust in companies, and sets the ground rules within which companies compete legitimately to provide the goods, services, jobs and wealth on which modern economies depend.

Society grants companies important rights and freedoms – such as the privilege of limited liability – and in return expects companies to fulfil certain obligations. The most basic terms of the corporate responsibility contract include duties to be honest, to keep promises, to take due care of the interests of others, to treat people fairly and respect their rights, and to be accountable.

These responsibilities pervade business life. They apply to all levels of the company, from the boardroom to the post room. They concern all business functions. Meeting them is everyone’s job; the corporate responsibility department cannot discharge them by itself.

People often misunderstand corporate responsibility. Some define it, mistakenly, as voluntary action beyond the requirements of the law. But this is only the tip of the iceberg. Corporate responsibility is also part of the law, its ethical principles shape legislation and regulatory guidelines.

Similarly, corporate responsibility sometimes appears to be extremely contentious. Debates about corporate responsibility highlight novel and controversial issues, diverting attention from the large body of corporate responsibilities that we accept and take for granted. Corporate responsibility also appears peripheral because of the media’s natural focus on the exceptions: cases where companies have done wrong. Behind these exceptions are a much larger set of routine and un-newsworthy examples where companies have succeeded in fulfilling their obligations.

Misunderstanding the true nature of corporate responsibility is the first obstacle to effective board action. Corporate responsibility is based on principles that are widely accepted and applied, and are frequently incorporated in regulation. It pervades business life and is the foundation of successful commercial relationships.

Corporate responsibility and value creation

The corporate responsibility contract is backed by a powerful system of incentives and sanctions – including laws, regulations, taxes and subsidies, licences and fines, and market-based instruments – that change the shape of markets and create material opportunities and risks for companies.

There are also less tangible rewards and penalties that can affect long-term value creation. Research shows there are powerful social rewards and sanctions associated with ethical standards. Acting responsibly generates trust, loyalty and goodwill among customers, employees, business partners and other stakeholders. Corporate irresponsibility, on the other hand, can result in disapproval and suspicion, public criticism, damage to customer loyalty, loss of brand equity and a tarnished corporate reputation. Within companies, responsible behaviour creates a sense of satisfaction and self-respect among employees; whereas irresponsibility can cause feelings of embarrassment, guilt, shame, cynicism and poor morale and commitment from employees. For these reasons fulfilling the corporate responsibility contract is a fundamental ingredient of sustainable long-term business success. People want to deal with honest companies that honour their promises and take due care to respect the rights and interests of others. Delivering corporate responsibility, in the face of pressures and temptations to do otherwise, can be a source of lasting competitive advantage.

Temptations and pressures to be irresponsible

Companies have little difficulty in behaving responsibly when markets reward them for doing so. However where market incentives are poorly aligned, there can be strong temptations and pressures to behave irresponsibly. This can lead companies, or those who work for them to renege on their contract with society.

Perhaps the most important source of unwelcome pressures is market failure. With market failure the short-term profit maximising strategy for companies may entail acting irresponsibly. Where this is so, pressure from competitors and investors can lead companies to breach corporate responsibility standards.

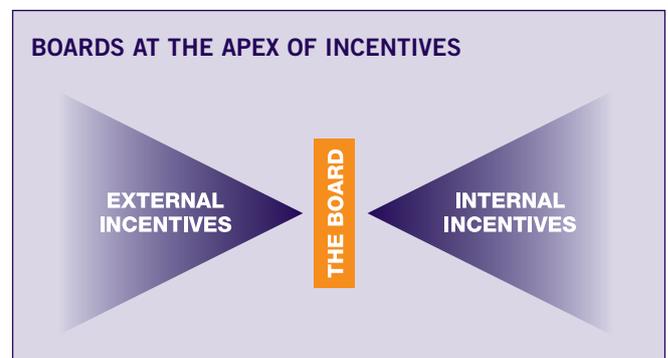
External incentives are not the only force that can lead companies astray. The organisation's own culture, objectives, performance targets and incentive schemes can create pressures and temptations for executives and staff to behave irresponsibly. A salesperson, for example, may be tempted to deceive a customer in order to complete the big sale that will meet their annual target and trigger a lucrative bonus.

Often the benefits of behaving irresponsibly are more apparent than real, because over the long-term they are often offset by larger costs in terms of lost trust, loyalty and reputation, and regulators' sanctions. The powerful rewards and penalties that support the corporate responsibility contract can deter irresponsibility, but only if they are understood and given due weight in decision making in the short-term.

The role of boards

The role of boards is to govern, not to manage. It is about setting overall direction, establishing boundaries and controls, recruiting and motivating talented executives and overseeing their operation of the business. Effective governance from the board is essential for companies to reap the long-term rewards for responsible behaviour and resist the pressures and temptations that will otherwise lead them astray.

Boards are in a unique position to play this role. They sit at the apex of the incentive structure for companies. They drive companies' response to external incentives provided by the market and regulatory environment, and shape their internal incentives. This means that boards can have a decisive role to play, both in removing unhelpful pressures and temptations, and reinforcing the rewards and penalties that support responsible behaviour.



Recommendations

Based on our analysis and consultation, we propose the following suggestions for board action. We recognise the debate about effective governance of corporate responsibility is in its early stages. So, our recommendations warrant further testing. The board should:

- **Set values and standards**
- **Think strategically about corporate responsibility**
- **Be constructive about regulation**
- **Align performance management**
- **Create a culture of integrity**
- **Use internal control to secure responsibility**

The recommendations are in more detail overleaf.

Executive Summary (continued)

Recommendations

Set values and standards

Be clear about the terms of the corporate responsibility contract, set explicit standards and values for the business.

Think strategically about corporate responsibility

Understand the problems in your markets, and design a business model that avoids them.

Be constructive about regulation

Support both self-regulation and government intervention to correct structural problems in markets.

Actions by the board

State the corporate responsibility standards that guide the board's decisions and the behaviour of executive management and staff.

Ensure the standards are appropriate, comprehensive, and consistent.

Ensure that corporate responsibility principles are communicated effectively to managers and staff.

Review the risks associated with strategy, including risks of breaching corporate responsibility standards.

Seek creative strategic responses to market failure.

Approve strategies that create value over the long-term and in broad terms, both tangible and intangible.

Support voluntary self-regulatory standards, and ensure the company complies.

Ensure the company plays a constructive role in seeking efficient and effective regulatory remedies.

Further suggestions

Reporting

It is important that shareholders and others understand the board governance of corporate responsibility; the company performance; and its relevance to the company's strategy. The board should:

- Include in the Operating and Financial Review (OFR), information on corporate responsibility, to the extent necessary for shareholders to understand the company's strategy, risks, resources or relationships.
- Include in its report on corporate governance, an explanation of the board's governance of the company's corporate responsibilities.
- Include in its remuneration report, information about how, if at all, long-term, intangible, and corporate responsibility factors are incorporated in the remuneration framework.
- Approve and issue a regular corporate responsibility report.

Align performance management

Reward responsible success over the long-term, and not just meet financial targets over the short-term.

Give due weight to long-term and intangible factors, and corporate responsibility, in the definition, measurement and recognition of success.

In remunerating executives: balance long-term and short-term rewards; use performance metrics that reflect both tangible and intangible value creation; and make rewards contingent on responsibility.

Ensure the company's risk management system reviews remuneration-driven risks of improper behaviour.

Create a culture of integrity

Set the right tone at the top and cultivate the right values in the corporate culture.

Meet their own standards and values in their decisions, and ensure that others do so.

Give priority to personal integrity in the recruitment and retention of directors, and throughout the company.

Foster a culture in which responsible behaviour is expected and lapses are noticed, criticised, and punished with appropriate sanctions.

Use internal control to secure responsibility

Safeguard the company's standards with robust internal audit and control systems.

Ensure corporate responsibility risks are formally included in the company's risk assessment procedures.

Ensure the internal control system audits adherence to the company's corporate responsibility standards.

Understand the expectations of the company's stakeholders about corporate responsibility, and their perceptions of its behaviour.

The role of board committees

- It is the remuneration committee's job to ensure – to the extent possible – that executive pay is aligned and not in conflict with corporate responsibility. The remuneration committee should also review the remuneration policy for executives at the level below the board to consider whether it is creating undesirable incentives.
- In recommending candidates for directorships to the board, it is the nominations committee's role

to ensure that due weight is given to character and integrity; and that this is reflected in the specification for the role, and in briefings to executive search consultants.

- Audit committees should review the company's system of internal control to ensure that it adequately identifies and manages corporate responsibility-related risks. The audit committee should also consider whether the company's internal audit procedures are effective at monitoring adherence to the company's standards and values.

INTRODUCTION

The context

Corporate responsibility has climbed the agenda in recent years. More and more companies publicly accept that they should meet certain basic obligations to customers, employees, business partners and other stakeholders. For example, the number of FTSE 100 members publishing specialist reports on this subject has risen from a handful, to over 80 in the last decade. Most companies now have corporate responsibility policies, management systems, and reporting frameworks. Chief Executives regularly talk about it in speeches. A small industry has grown up to advise, assess and engage companies on corporate responsibility. Both the Financial Times and the Economist¹ have judged the subject important enough to justify special supplements. Corporate responsibility is even listed in a government ministerial portfolio.

At the same time there has been much discussion about the role of boards, particularly in the context of the Combined Code on Corporate Governance and the Turnbull, Higgs and Smith reviews².

Strangely perhaps, there has been little consideration of how these two areas interrelate, or the specific role of boards in corporate responsibility. There is much advice on governance but, with a few exceptions,³ it offers little on questions of corporate responsibility. The Combined Code itself states: “directors should set the values and standards of the company and ensure that it meets its obligations to shareholders and others”.⁴ This signals that the board has a role to play in standard setting and enforcement, but gives no detailed guidance. Neither does the Company Law Review, which has proposed changes to the duties of directors, requiring that they consider the interests of stakeholders other than the shareholders.⁵

The lack of guidance has not stopped boards coming up with their own approaches – and this report has benefited from the accumulated wisdom from boards who have grappled with this question.⁶ But given the importance of corporate responsibility, the three organisations involved in this study (Business in the Community, FTSE Group and Insight Investment) consider it timely to address the question of what boards specifically should do to ensure corporate responsibility.

The need for consensus on the board’s contribution

There are important practical reasons for this enquiry. The 1995 Pensions Act requires pension funds to state the extent to which they take account of social, ethical or environmental issues in investment. Many pension schemes – particularly in the public sector – have a stated policy of taking account of corporate responsibility in managing their funds, whether by incorporating it in financial analysis or shareholder activism. Many large institutional investors have therefore started to discuss questions of corporate responsibility in their meetings with company directors.⁷ Rather than each investor making different and even inconsistent demands on companies, it would be useful if there was clarity about what is reasonable for shareholders to expect from boards on the topic of corporate responsibility. Board directors have also made clear that they would like more consistent signals from investors on the governance of corporate responsibility.

Partially as a consequence of this, various indices and benchmarking frameworks have emerged to assess and compare companies’ approach to corporate responsibility and governance, some of which already include the quality of the board’s contribution. Business in the Community and FTSE Group both compile indices on these topics.⁸

But, as we discuss in Section 1 of this report, there are more fundamental reasons for looking at boards’ governance of corporate responsibility. We argue that corporate responsibility sets the terms of an implicit contract between companies and society and is therefore a pre-requisite for long-term value creation.

Our approach

The executive management of corporate responsibility is already the subject of extensive guidance. This report is about how companies should be governed so they behave responsibly. Its recommendations work within the generally accepted role of boards – particularly as set out in the Combined Code – rather than inventing new roles for directors. We recognise the heavy demands already placed on the boards of listed companies, but suggest that, even though corporate responsibility is often challenging, effective board action need not create much extra work. Our recommendations involve making modest changes to existing practices rather than starting new ones. In researching this report, we have consulted over

40 board directors, company secretaries and corporate responsibility practitioners from 20 large UK companies, partly to understand how their boards approach corporate responsibility, and partly to test the ideas and arguments presented here.

The focus of this report is on governance of corporate responsibility for UK listed companies. While the principles recommended in this report apply elsewhere, many of our specific suggestions relate to particular board structures used by UK plcs.

We illustrate many of our main recommendations with cases studies of current corporate practice. The intent behind this is to show how the boards of some companies are governing corporate responsibility, not to put the companies concerned on a pedestal. Many of these companies have stressed that their approach to corporate responsibility is not perfect, but is work in progress.

One of the biggest obstacles to clear thinking about board action on corporate responsibility, is confusion about the meaning of the term. People often define corporate responsibility in a way that gives it marginal relevance to the role of the board. This report aims to remove this confusion by clarifying the true nature of corporate responsibility and why it is central to the board's role.

We then proceed to ask what causes companies to breach standards of corporate responsibility, and consider what boards can sensibly do about it. The main cause of corporate irresponsibility is misaligned incentives; market failure and internal reward structures can create pressures and temptations for companies and their employees to behave irresponsibly.

We conclude that the secret of effective board action on corporate responsibility is responding to these misaligned incentives to ensure that virtue is rewarded. Boards sit at the apex of the incentive structure in companies. Their leadership and example, and decisions about strategy, standards, remuneration, performance management and internal control, are critical in enabling companies to resist the pressures and temptations that may lead them to act irresponsibly. Boards are by no means the only ones with a role in achieving this, but effective action by boards can be decisive.

1. THE NATURE AND SIGNIFICANCE OF CORPORATE RESPONSIBILITY

Before considering what boards need to do to ensure companies behave responsibly, we need to be clear about the nature of corporate responsibility, including why it is a central topic for boards.

The corporate responsibility contract

Corporate responsibility sets the terms of an implicit contract between companies and their customers, employees, business partners and wider society. This contract is a foundation of our free market system and is enormously valuable to all parties. It establishes the shared expectations on which people place their trust in companies, and sets the ground rules within which companies compete legitimately to provide the goods, services, jobs and wealth on which modern economies depend.

Society grants companies important rights and freedoms – such as the privilege of limited liability – and in return expects companies to fulfil certain obligations. The most basic terms of the corporate responsibility contract include duties to be honest, to keep promises, to take due care of the interests of others, to treat people fairly and respect their rights, and to be accountable.

Corporate responsibility sets the terms of an implicit contract between companies and their customers, employees, business partners and wider society.

Sometimes companies – or those who work for them – face incentives to act in ways that are individually beneficial but collectively harmful. The boundaries set by the corporate responsibility contract impose limits on the pursuit of self-interest to enable collectively valuable outcomes. It sets the rules of the game by assigning duties and rights between companies, their employees and wider society – delivering more transparent markets, more reliable product and service propositions, less risk

and uncertainty for stakeholders, a more equitable and trustworthy working environment, and fewer harmful impacts on society and the environment.

The corporate responsibility contract does not only impose burdens on companies, it also sets limits on what others can reasonably expect of them. Companies must take due care, not infinite care; they must treat people fairly, not indulge their every need. Corporate responsibility is not an open-ended ethical requirement for companies to serve the public interest, by, for example, single-handedly ending poverty, eliminating disease, or stabilising the global climate.⁹ Instead it imposes specific obligations.

Corporate responsibility principles apply to all aspects of business and at all levels in the company – from the boardroom to the post-room. Meeting these obligations is everyone's job; it is not something that can or should be delegated solely to a corporate responsibility department.

A clearer view of corporate responsibility

Corporate responsibility appears to be the subject of endless disagreement. Much of the debate revolves around the most controversial and challenging aspects of corporate responsibility, often at the outer limits of a company's reach; issues such as working conditions in supply chains, climate change, obesity, or complicity in human rights abuses. This should be no surprise – these are important topics, and exercise the most concern and interest among corporate responsibility specialists, journalists, pressure groups and politicians. But over emphasis on the most extreme issues hides the fact that behind the controversies, there is also a great deal that is settled and agreed. How many business leaders seriously dispute the idea that companies have a duty to be honest or treat people fairly? But there is often disagreement about what is required in practice. Exactly how much care, for example, should food companies take to tell their obese customers about the risks associated with their products?

Similarly, discussion of corporate responsibility often focuses on the failures. Responsible behaviour is typically boring, whereas corporate irresponsibility is newsworthy. This leads to a focus in the media on companies that have failed to behave responsibly, obscuring the success most companies achieve in fulfilling their corporate responsibilities most of the time.

1.1 Corporate responsibility and the law

One of the most important misconceptions about corporate responsibility concerns its relationship with the law. Some people – even some branches of government¹⁰ – define corporate responsibility as voluntary action beyond the requirements of the law. But this is just the tip of the iceberg; corporate responsibility principles lie at the heart of most business legislation and regulatory guidelines. As one company chairman put it: “corporate responsibility is about complying with the spirit as well as the letter of the law”. For example, the 1979 Sale of Goods Act requires companies to be honest about the nature of the goods they are selling.¹¹ The Advertising Standards Authority requires that “All marketing communications should be legal, decent, honest and truthful.”¹² The Financial Services Authority’s regulatory handbook requires companies to conduct its business with “integrity”, to control its affairs “responsibly”, pay “due regard to the interests” of its customers and treat them “fairly”¹³. There is also a large body of employment law that requires companies to respect the rights of their staff, for example, not to be discriminated against on grounds of sex.¹⁴ The Health and Safety at Work Act 1974 creates a duty on companies to take due care to ensure the health, safety and welfare at work of employees.¹⁵

It should be no surprise that the law often embodies corporate responsibility principles. The purpose of both is the same, to set limits on the actions of individuals and companies in order to serve collective interests.

Points of difference

While law and corporate responsibility overlap, they are not identical. Not all laws are good laws. This can create difficult dilemmas for boards, as companies operating in South Africa during apartheid and Germany in the 1930s knew to their cost. There are also less dramatic examples, where the law is not unjust, merely misconceived. For example, where unintended consequences make a regulation worse than the problem it set out to remedy. While companies may need to comply with misconceived laws, such laws hardly embody corporate responsibility.



Another way in which law and corporate responsibility diverge is where law is absent or ineffective. This is true, for example, in failed or developing states that lack the capacity or the will to regulate effectively. Corporate responsibility principles then provide a guide to corporate behaviour in the absence of effective law.¹⁶ It is also true for emerging issues of concern, in the period before public opinion has settled to the extent necessary to support legislation. Many new technologies become the focus of debates about corporate responsibility long before they become the subject of law.

Cutting red tape

There is a larger question here. Might the public interest sometimes be better served if governments left companies to regulate themselves based on corporate responsibility standards? Institutional economists argue that in regulating companies there is a choice to make between government regulation, based on prescriptive rules, and self-regulation based on principles;¹⁷ a choice between the explicit contract expressed in formal regulation, and the implicit contract of corporate responsibility.

If boards can be successful in ensuring that companies consistently meet principles of corporate responsibility, society may be better off as we rely more on the implicit corporate responsibility contracts and less on prescriptive rules. Given that government regulation can have significant costs and unintended consequences, principle-based self-regulation may in some circumstances offer a cheaper and more flexible means of achieving public policy goals.

There are some signs the UK government may be coming to accept this logic. Commenting on the recent Hampton Review¹⁸, the Chancellor of the Exchequer recently said,

“a new trust between business and government is possible, founded on the responsible company, the engaged employee, the educated consumer – and government concentrating its energies on dealing not with every trader but with the bad trader, who should not be allowed to undercut the good. This new risk-based approach has wide application from environmental health to financial services and even taxation.”¹⁹

The Hampton Review proposes that companies that prove they can be trusted to behave responsibly should face a lower burden of regulatory inspection and enforcement. If the government carries out Hampton’s recommendations, then effective board action on corporate responsibility will deliver immediate benefit. The Review is mainly about reducing the burden of regulatory enforcement, not rolling back regulation itself, but if the Hampton experiment is successful there will surely be a good case for going further.

1.2 Corporate responsibility and value creation

The corporate responsibility contract is mutually valuable. Customers and employees want to be able to trust companies to tell them the truth, keep promises, take due care of their interests, and treat them fairly. In return they have good reason to reward companies who can deliver these things, with their loyalty and commitment, preferring them to their untrustworthy alternatives. Both sides benefit.

Rewards and penalties

The corporate responsibility contract is supported and enforced by deep-seated psychological and social mechanisms, as well as by formal regulatory penalties. New research in economics reveals that people show strong behavioural dispositions to value and reward responsible behaviour, and disapprove and punish irresponsibility (see box below). People admire and respect those who behave responsibly, particularly in difficult circumstances. Conversely, they express disapproval, resentment and indignation at those

who fail to do so. Many will make a real effort to reward admirable behaviour and will go out of their way to see cheats get their come-uppance.²⁰

All of this matters to value creation. There are good reasons to expect customers, employees, business partners and others to reward responsible behaviour with their loyalty, commitment and advocacy. And there are equally good reasons to expect them to punish irresponsibility with dissatisfaction, defections to competitors, public criticism, and consequent damage to brand and reputation. Intangible factors such as these can be powerful long-term value drivers for companies.²¹ Because of this, corporate responsibility deserves to be a part of companies' basic value propositions.

A reputation for integrity and trustworthiness is a potentially valuable asset and can provide strategic advantages to businesses that invest in it. The harder it is to come by, the more valuable this reputation becomes. The existence of pressures and temptations to behave irresponsibly in some markets can make it difficult to behave responsibly consistently, but the fact that corporate responsibility might be difficult to supply,

MORAL SANCTIONS

Traditional economics assumes that behaviour is motivated by self-interest. This assumption is a powerful and simplifying one, but it is an obstacle to understanding the role of corporate responsibility in business. The problem is that ethics and self-interest are often in conflict, and if the economists' assumption is right, then self-interest will always win, and ethical standards will be powerless to motivate behaviour.²² Fortunately economists have started to change their minds about the self-interest assumption.

Experimental economists test economic theories by getting people to play games. The Ultimatum Game, has two players called the Proposer and the Responder. The Proposer is asked to say how he wants to divide a sum of money, say £100, between the two players. He may, for example, choose to keep £90 himself and offer the Responder £10. The Responder is then asked to decide whether he accepts or rejects the proposed division. If he accepts it, the money is shared as proposed. If not, then neither gets anything. The players are anonymous and only play the game once, so considerations such as building a good reputation should have no bearing. The standard 'self-interest' prediction suggests the Proposer will propose a division in which he gets £99 and the Responder gets £1, because this is the division that maximises his pay out. More surprisingly perhaps, self-interest also predicts the Responder will accept this division when

it is offered: getting £1 is better than getting nothing (which will be the result if the Responder rejects the offer).

Experimental economists, however, have found that this is not what happens in practice²³. In fact, only a minority of participants behave in this way. The most common offer is a 50:50 division of the money, and Responders typically reject offers below 30%. When asked to explain why they propose 50:50 divisions, Proposers say that to do otherwise would be considered unfair. Similarly, when asked why they reject divisions of less than 30%, Responders say that they do so to punish unfairness. The evidence suggests that ethical judgement, not just self-interest, motivates behaviour.

Recently, some experimenters have used brain scanners to see what is going on in people's heads when playing these games. When faced with the opportunity to punish unfair behaviour, they find activity in the parts of the brain associated with powerful emotional rewards (see picture)²⁴, showing that people gain satisfaction from seeing justice done. Powerful emotions of pride, guilt, shame, indignation and resentment play a part in driving this behaviour.

The fact that most people will comply with and enforce ethical standards, even at some expense to themselves,²⁵ provides a powerful support for the corporate responsibility contract.

does not mean it is not demanded. In markets where trust is scarce people will pay an even greater premium for trustworthy products and services. Companies that behave responsibly where others fail to do so will enjoy a hard-to-copy source of competitive advantage.

But the corporate responsibility contract does not just rely on informal psychological and social mechanisms for its enforcement. Where corporate responsibility principles are incorporated in regulation, legal sanctions will support and enforce responsible behaviour. Responsible companies will have good relationships with regulators and – if the government carries out the Hampton recommendations – receive a lighter burden of regulatory enforcements. Irresponsible companies face shaming, fines, compensation payments, litigation, and, in extreme cases, the loss of their licence to do business.

Company law reform

The powerful mechanisms that support the corporate responsibility contract mean that corporate responsibility is of central importance to value creation and a duty of the board. The UK Company Law Review accepted this conclusion.²⁶ The so-called ‘Enlightened Shareholder Value’ argument suggests that directors should have a duty to behave responsibly and respect the interests of others, because this is the enlightened way to create long-term shareholder value. In line with the White Paper,²⁷ the Company Law Reform Bill reflects this conclusion. If the current wording is enacted, in promoting the success of the company, directors will have a duty to take account of: the interests of other stakeholders; the company’s social and environmental impacts; and its reputation for integrity.²⁸ Many of the board directors consulted in the preparation of this report endorsed the Enlightened Shareholder Value model and expressed strong support for the idea that corporate responsibility is in the interests of their business.

1.3 A binding contract

The above arguments support the view that corporate responsibility is the enlightened route to shareholder value over the long-term, but they do not prove that ‘enlightenment’ and shareholder value creation will always necessarily go hand in hand. The economic literature on market failure provides an array of examples where the interests of companies and the interests of society diverge. As we will discuss in Section 2, misleading customers and externalising environmental costs can increase profits, at least in the short-term. Where the penalties for irresponsibility are smaller than the benefits which can be obtained by exploiting market failure, enlightened business practice may be at odds with directors’ duty to create shareholder value. Here, cold self-interest suggests

the company should take the increased profits and ignore the consequences.

But this is where the idea that corporate responsibility is a binding contract matters most. As *The Economist* recently put it:

“...managers ought to behave ethically as they pursue the proper business goal of maximising owner value – and that puts real constraints on their actions. In most cases, acting within these constraints advances the aim of the business, just as individuals find that enlightened self-interest and ethical conduct usually sit well together. But, for firms as for people, this will not always be true. Sometimes the aims of the business and rational self-interest will clash with ethics, and when they do, those aims and interests must give way.”²⁹

Directors’ duties to shareholders do not over-ride the terms of the corporate responsibility contract and the legal and ethical duties that constitute it. The point of the implicit contract is to constrain the pursuit of harmful self-interest to secure mutual advantage over the long-term. If companies and their directors were permitted to disregard their ethical duties whenever they conflict with the immediate interests of shareholders, the corporate responsibility contract – and the mutual benefits that result from it – would be fatally undermined. It would no longer provide a reliable basis for the public’s trust in business.³⁰

While shareholders have every right to expect directors to serve their interests, they do not have a right to expect directors to lie, cheat, or neglect the interests and rights of others in order to do so. Companies exist because society supports the legal frameworks that make incorporation possible. They enjoy considerable privileges and protections that society has conferred on them – including limited liability protections for shareholders. It is therefore not unreasonable for society to expect them to meet the basic standards of responsible behaviour necessary to protect the public interest.³¹

The fact that corporate responsibility might be difficult to supply, does not mean it is not demanded.

2. BOARD ACTION ON CORPORATE RESPONSIBILITY

2.1 The role of boards

What contribution can boards make to ensure that their companies act responsibly?

The role of boards is different in important respects from that of executive managers. It is to govern, not to manage. It is about setting overall direction, establishing boundaries and controls, recruiting and motivating talented executives and overseeing their operation of the business. In doing so, it is about ensuring the company

meets “its obligations to shareholders and others”. The board’s governance role places it in a decisive position to address the pressures and temptations that lead to corporate irresponsibility.

In the UK, the boards of listed companies rely on striking a balance between executive and non-executive directors; combining the executives’ fine-grained understanding of the business, with the non-executives’ independent, unconflicted ability to take the long view, and shape strategy and incentives accordingly. This dynamic is

CASE STUDY: BP GOVERNANCE – DEFINING STANDARDS THROUGH BOARD POLICY

The board of BP has clearly articulated its role as the governance of the Company, exercising its unique role in the representation and promotion of shareholders’ interests. To do this, the board governs through making policy. These policies define BP’s long-term goals and establish the values and behavioural standards of the Company by circumscribing the limits of executive action in pursuit of these goals.

BP’s approach reflects what has come to be known as the “policy governance” approach, and is characterised by very high levels of delegation within a robust policy framework of objectives and constraints. In simple terms the executive management of the company is free to exercise the authority delegated to it by the board to pursue whatever course it determines will meet the objectives set by the board as long as it remains within the behavioural limits set by the policy framework; the board’s principal contribution to value creation, therefore, lies in setting the right policies.

The board of BP has reserved to itself broad policy decisions, delegating all other considerations in the running of the business to the Group Chief Executive. Thus the board governs BP by articulating its objective, setting general policy for the conduct of the business and by monitoring the observance of these two elements by the executive.

There are a number of elements to the BP board’s policies:

- The Goals Policy sets out the long term objectives for the Company.

- The Board-Executive Linkage Policy defines the manner in which authority is delegated to the Group Chief Executive and the interaction between the board and its delegate – the Group Chief Executive.
- The Executive Limitations Policy is the principal vehicle by which the board defines values and standards for the business. This policy addresses matters of risk, financing, and internal control as well as explicit standards in the areas of the environment, health and safety, ethical conduct, the treatment of employees and politics.

Since 1996, the BP board has operated a dedicated board committee, the Ethics and Environment Assurance Committee, comprised of non-executive directors, to review corporate responsibility issues. This committee is tasked specifically with monitoring the observance of the Executive Limitations Policy relating to non-financial risks. BP’s CEO has given effect to the Executive Limitations Policy by creating a detailed Code of Conduct and various systems for training and monitoring adherence to it.

BP believes that its approach: empowers executive management to act quickly in pursuit of business objectives; creates less cluttered board agendas and consequently raises the quality of debate on strategic matters, and their impact on the goals, limitations and values of the Company. As a result behavioural standards are considered at the highest level and have real impact in the Company. This model places the setting of values and standards squarely at the heart of the board’s role.

important in understanding the board's role in corporate responsibility.

2.2 Setting standards

The Combined Code on Corporate Governance states, "The board should set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met." (A.1). This principle creates the expectation that boards have a fundamental role to play in ensuring companies behave responsibly. As with other aspects of the Combined Code, boards must apply this guidance, or explain in their annual report why they have chosen not to do so.

This principle is an essential foundation for effective board action requiring boards to set the standards and values for the business. Differences in companies' cultures and business activities mean that their standards and values will vary. However, certain widely accepted and legally mandated corporate responsibility principles will be relevant to every company (see p.12). An essential part of the board's role is to make clear the principles of corporate responsibility that govern the company's actions. **Boards should state the standards that guide their decisions and the behaviour of executive management and staff.**

Boards³² of 73 FTSE 100 companies have approved a public statement of business principles expressing the standards and values they expect the company to adhere to.³³ These statements vary in their quality: some are a little vague, some fail to distinguish between aspiration and expectation, some have unexpected omissions, and some are not consistently reflected in other company policies. **Boards should ensure the standards they set are appropriate, comprehensive and consistent.**

The board's statement of business principles helps remove uncertainty about the boundaries within which the company should operate. It provides the basis on which policies are endorsed and enforced, both informally in the corporate culture, and formally through internal control and disciplinary procedures. And it creates an explicit basis on which the board can assess its own effectiveness, and that of the executive in meeting the company's obligations.

2.3 Managing incentives

A statement of corporate responsibility is valuable and necessary but, by itself, espousing values is often not enough to ensure the company behaves responsibly. The problem is that statements of principles do not themselves address the pressures for executives and staff to breach them. The key to effective board action on

corporate responsibility lies in understanding and managing the incentives that cause unhelpful temptations. By incentives, we do not just mean financial incentives associated with remuneration, but include factors which motivate behaviour: recognition, status, career progression, disciplinary sanctions and the intrinsic satisfaction of a job well done. If people believe that responsibility will be rewarded – in these broad terms – they are likely to act accordingly. If, on the other hand, they believe that integrity is not valued or, even worse, unethical behaviour is tacitly rewarded, they are more likely to succumb to temptations.³⁴



Two levels of incentives

Undesirable incentives can surface at two levels: the external market environment and inside the business. Externally, market failure can create pressures for the company to behave irresponsibly. Internally, remuneration systems, performance management frameworks and flawed corporate cultures can tempt people to act wrongly.

However, not all incentives are unhelpful, there are various market and non-market mechanisms that reward responsible behaviour and penalise irresponsibility, which apply both outside and within companies. Where harmful incentives exist, the challenge is therefore to remove or to neutralise them by strengthening the rewards for responsible behaviour. Boards are uniquely well-placed to address this as they sit at the apex of the incentive-structure in companies, at the junction where external and internal incentives meet (see diagram). The board's response to external incentives and the shape it gives to internal incentives can therefore be decisive in achieving corporate responsibility.

Board directors are by no means the only people with a role to play here (see Section 5.3), but their contribution is vital. Given that a reputation for integrity and trustworthiness is an enormously valuable asset, it is a role that most boards want to play.

3. MANAGING EXTERNAL INCENTIVES

3.1 Market failure

Market failure is the most important external driver of irresponsible behaviour.³⁵ Under favourable conditions markets reward companies for behaving responsibly. Consider a competitive market with well-informed customers who can easily tell whether they are getting value for money. If a company acts irresponsibly by making misleading statements about its products, promising more than it delivers, or failing to take due care to ensure quality or safety, then customers will find out soon enough and take their custom elsewhere. This market rewards responsibility. Where markets work well, the pressures and temptations to behave wrongly are less likely to arise.

Economists have identified various conditions for effective markets (see box below). Where these are lacking, markets fail to deliver optimal social outcomes, and

companies are often led to behave irresponsibly in the process. In situations of market failure, companies can prosper by exploiting customer ignorance, abusing their market power, or reduce their costs by externalising them.

Market failure is a matter of degree. No market is perfect and, conversely, even the most flawed markets can deliver some useful outcomes. Some market failures, therefore, do little harm and raise few questions of corporate responsibility. But often exploiting market failure means breaching accepted standards of corporate responsibility. For example, exploiting asymmetric information involves – at the least – withholding important information from customers, and often more overt forms of misdirection and deception. Similarly, by externalising costs, companies may fail to exercise due care to respect the interests of others or breach their basic human rights. Market failure problems are therefore a common factor in a wide range of corporate

VARIETIES OF MARKET FAILURE

Markets often align the interests of participants. In order to maximise financial returns for shareholders, companies provide goods or services to customers, making both sides better off. To deliver this benefit, markets need healthy competition, free flows of information and an absence of harmful externalities. When these conditions are not present, companies can face strong incentives to act in ways that can be socially harmful and irresponsible.³⁶

Negative externalities

Negative externalities occur when the actions of market participants impose costs on others. An example of a negative externality is environmental pollution, where the costs of, say, emitting carbon dioxide into the atmosphere are not borne by the companies or individuals responsible but by those affected by climate change. Where it is possible to externalise costs, companies will often benefit by doing so, increasing their profitability as a result. But this imposition of costs on others will often breach accepted standards of individual or corporate responsibility.³⁷

Public goods

Examples of public goods include clean air, rainforests and ocean fisheries, national defence, policing, and the provision of roads and lighting in public places. It is in the collective interest that these goods are provided,

however it is difficult to charge individuals for their use.³⁸ Markets therefore give little incentive to companies to provide public goods. Typically, governments fill the gap, but there are increasing questions about what responsibilities – if any – companies might have in this area.

Competition problems

In non-competitive markets, companies have the power to influence the price or quantity of goods sold. Where companies exploit this power consumers can get a bad deal, weaker competitors can go out of business, and for these and other reasons the public interest is not well served. Because of this, abusing market power is frequently considered socially irresponsible and is often illegal; as is the case with activities such as predatory pricing, price-fixing, some kinds of price discrimination, and various kinds of collusion.

Information asymmetry

Often in markets companies know more about the quality, pricing and value of their products than their customers. Where consumers cannot accurately assess value, companies have an incentive to exploit their ignorance by overcharging or under-delivering on quality. In markets where consumers cannot quickly spot and redress these problems, they undermine customer trust and ultimately damage participation in the market.

responsibility issues. They are, for example, present in issues such as climate change, toxic chemical emissions, natural resource depletion, health and safety breaches, product safety failures, price-rigging, the abuse of monopoly power, the mis-selling of various complex or risky products, irresponsible marketing and advertising, and some forms of social exclusion.

Market failures can result in strategies and business models that breach standards of corporate responsibility, but can be more profitable – at least over the short-term – than the responsible alternatives. As a result, pressures emerge to act wrongly. The forces that normally work so well to drive positive outcomes in markets instead pull companies in the opposite direction. To beat the competition, the operations director may be tempted, for example, to seek to create a cost advantage by aggressively externalising costs and harming others in the process. To hit this year's revenue target, the marketing director may be tempted to approve advertising that mis-informed customers about a product's quality or value. To satisfy investor pressure to hit quarterly earnings forecasts, the CEO may be tempted to avoid asking too many questions about the levels of care employed in running a hazardous facility.³⁹

3.2 Understanding the risks

What can boards do to deliver corporate responsibility in the face of market failure? Understanding is the first step; boards need to consider the long-term risks associated with their business model, trying particularly to identify where it makes use of harmful market failure. Does it externalise large costs on society? Are customers able to make rational, well-informed decisions about products? Would the business model be viable in a fully competitive market? If the answer to any of these questions is no, then there are likely to be strategic risks associated with corporate responsibility. **Boards should review the risks associated with their strategies, including the risks of breaching corporate responsibility standards.** It is important to look into these matters when the board considers new strategies or when moving the company into new territories or markets. This type of strategic review is a core function of the board.

Following the Turnbull Report,⁴⁰ many boards have developed a more systematic approach to risk management, and many companies explicitly incorporate strategic corporate responsibility risks as part of the process. In 2001, the Association of British Insurers – a large association of UK institutional investors – gave further impetus to this development by issuing guidelines for disclosure by companies of significant risks associated with corporate responsibility.⁴¹

3.3 Changing the business model

Where boards identify significant market failure-related risks, what can they do? One response is to adjust the business model to avoid or reduce undesirable incentives. For example, if the problem with the market is that customers do not understand the products, it may be possible to design simpler products that customers find easier to evaluate. Similarly, if the problem with the market is externalities associated with the carbon emitted from the cars you make, it may be possible to offer a car with lower emissions. Advocates of 'eco-efficiency' have provided many examples where inventive products or business models remove or reduce environmental externalities – and increase profits as a result.⁴² BP, for example, reports that its voluntary internalisation of CO₂ emissions has saved it a net \$600m in costs.⁴³ A well-informed board with a deep understanding of its business model and the markets in which it operates is likely to have a good grasp of any associated market failures and the risks these create for the business. When faced with market failure the board should support and challenge the executive to design creative long-term strategies that align the business model with corporate responsibility. **Boards should seek to devise creative strategic responses to market failure.**

3.4 Getting the right regulation

In practice it is not always possible to redesign business models and reinvent markets, and as a result social pressure often mounts for enforcement of the implicit corporate responsibility contract. As discussed in Section 1.2, this can either happen through formal government intervention, or through self-regulation based on voluntary compliance with standards, backed by informal sanctions of various kinds.

Regulation corrects market failure by creating counter incentives or by cancelling the benefits from market failure. Where there are no other alternatives to respond to harmful market failures, boards have a duty to play a constructive role in securing effective regulatory remedies. As we discussed in Section 1, there are choices to make about how to regulate business in these circumstances. At one extreme there is prescriptive government regulation, at the other is self-regulation based on voluntary standards. In the middle are various fiscal and economic instruments. Each approach has strengths and weaknesses, and different approaches can be combined to give the best solution.

Self-regulation

Voluntary self-regulation can have the advantage of increased flexibility and lower costs, but sceptics often criticise its effectiveness. Evidence is emerging however, that self-regulation based on voluntary corporate responsibility standards can be effective.⁴⁴ This approach is dependent on companies' commitment to comply – and the willingness of their boards to provide the necessary leadership. It also depends on informal sanctions for non-compliance, such as damage to reputation.⁴⁵

Self-regulation has an obvious role to play in failed or developing states and other countries where governments lack the capacity or the will to regulate effectively.⁴⁶ But it is also essential to legal compliance in developed markets. And, if the recommendations of the Hampton review are carried out, self-regulation may play a more

important role in the future. **Boards should support the development of voluntary self-regulatory standards, and ensure the company complies.**

Government intervention

Where companies fail to regulate their own behaviour voluntarily, government intervention may be the only available remedy for market failure. Where this is so, **boards should ensure the company plays a constructive role in seeking effective regulatory remedies.** Boards should ensure the company does not, through its lobbying efforts (whether direct or by trade associations or other proxies), seek to subvert legitimate regulatory interventions,⁴⁷ though, of course, companies have a proper part to play in the public debate about what interventions are likely to be the most effective and efficient.

CASE STUDY: ADDRESSING MARKET FAILURE BY CHANGING THE BUSINESS MODEL

Halifax Financial Services has addressed information problems in its marketplace by adopting a strategy based on offering simple, easy to understand products.

The UK financial services marketplace has been beset by a series of events in which products have been mis-sold by providers or mis-bought by customers. At the heart of this problem lies a market failure caused by information asymmetries: products are often complicated and customers are often not knowledgeable about financial services. Mis-buying is therefore a risk and incentives exist for providers to mis-sell.

One way out of this problem is to reinvent the market by promoting much simpler products and investing in consumer education. In recent years Halifax, retail banking subsidiary of HBOS plc, has sought to do just this. HBOS believes that its most important corporate responsibility is to ensure that its customers buy products that are right for them. It aims to fulfil this responsibility by promoting a much simpler product range in a more transparent manner; and for higher risk products, checking that products meet customer-defined customer needs. The HBOS Foundation also invests in educating consumers about financial services.

These twin approaches reduce the information asymmetries, removing the cause of the market failure. This strategy has also been commercially successful.

CASE STUDY: BA PLAYS A CONSTRUCTIVE ROLE IN A REGULATORY REMEDY

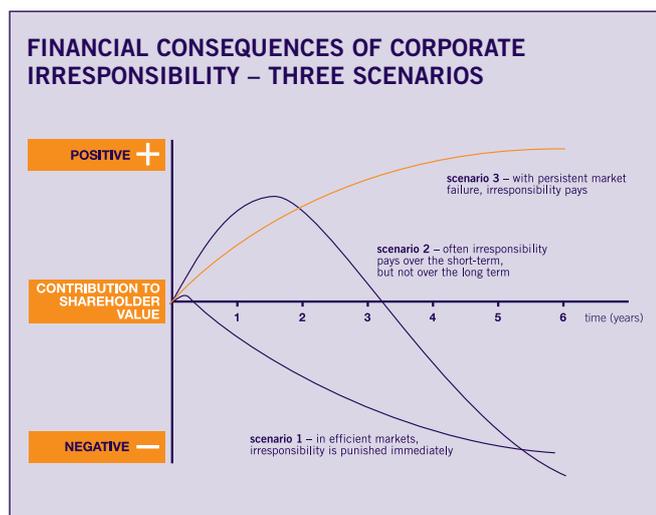
With the support of its Board, British Airways adopted advocacy to address environmental externalities associated with carbon emissions from air travel.

Carbon emissions from air travel are responsible for around 2-3% of human-induced global warming and the air travel market is growing by around 5% per year. These carbon emissions constitute an environmental externality, contributing to the huge potential costs for current and future generations arising from climate change. One means to correct this market failure is to put a price on carbon emissions. The Kyoto protocol and the related European Union Emissions Trading Scheme (EU ETS) is intended to do this. However, the airline industry has so far been exempted from this regulatory framework.

In March 2005, the chief executive of British Airways, appealed to the global aviation industry to work together to develop an effective strategy to reduce CO₂ emissions. He expressed support for a market-based approach based on pricing emissions and suggested that the airline industry should be included in the EU ETS. He argued that this is the most economically and environmentally effective way to approach the issue and also suggested that improvements in air traffic management systems – such as shorter flight path routes, less stacking and the use of continuous descent landings – might cut emissions by up to 12%. Given the fact that many air traffic systems are government controlled, he also appealed to governments to support this initiative. This constitutes a constructive approach to seeking regulatory solutions to market failure.

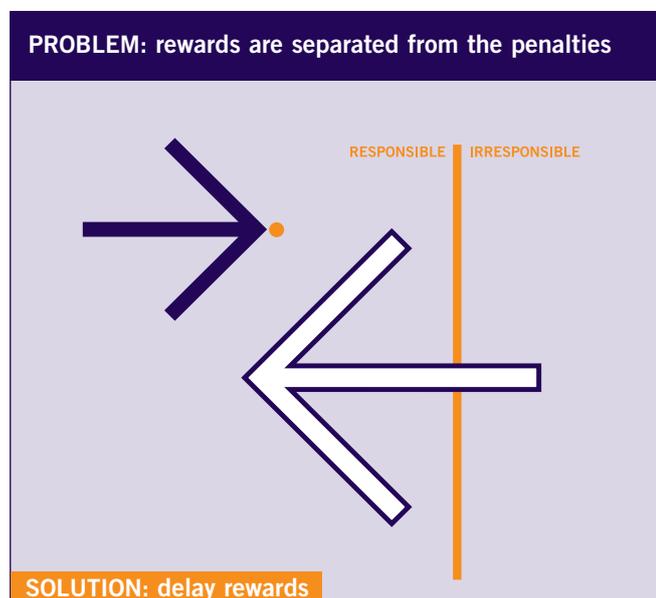
3.5 Short-termism and problems with intangibles

Where exploiting market failure is harmful and breaches the implicit contract between companies and society, the benefits for companies are often more apparent than real. Breaching accepted standards of responsible behaviour can have large costs, arising both from formal regulatory sanctions, and also from damaged commercial relationships and reputation, as discussed in Section 1. Companies often exploit market failure nevertheless. And when they do so, it is often because of short-termism and difficulties in giving weight to intangible assets.



Time horizons

Short-termism is a problem, in this context, because the benefits of exploiting harmful market failures are often immediate – they arise from current market transaction. However, the costs of acting irresponsibly accrue only over the long-term. It takes time for regulatory and social sanctions to impose costs on companies.



CASE STUDY: WESTPAC FACTORS LONG-TERM INTANGIBLES INTO ITS BUSINESS MODEL

Successful Australian bank Westpac supports its core business strategy of growth through service excellence by measuring the opinions of its stakeholders. It has mapped out the intangibles that it considers important to long term success, and has developed ways to measure them.

Despite having only a small office in the UK, Australian bank Westpac has been the subject of great interest since it took the top spot in Business in the Community's Corporate Responsibility Index last year. The bank, founded originally in 1817 as the Bank of New South Wales, is one of the top ten companies on the Australian Stock Exchange, and is one of Australia's leading banks. In 2004 it made a profit of 2.5Bn Australian dollars, with an asset base of A\$245bn.

Westpac has an explicit model of how it believes it can create superior shareholder returns over time. At the heart of this model is its 'service-profit chain'. This chain starts with achieving high employee commitment, which leads to higher retention, and productivity; which leads to a superior customer experience, and so to higher satisfaction and loyalty; which leads to higher revenue growth and profitability. Many companies focus too much on measuring and rewarding performance at the end of this chain. Westpac believes that you need to measure performance across the whole chain, and use performance indicators from right across the chain to measure and remunerate individual and collective performance.

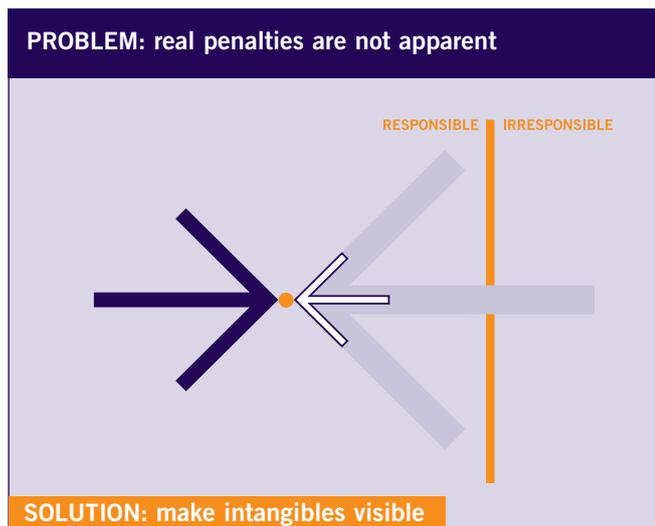
As Westpac states in its annual report: "Non-financial KPIs are included as performance conditions for executive remuneration because they address the needs of key stakeholders and are the leading indicators of future, sustainable value for our shareholders. The non-financial KPIs that form part of our executive scoreboards, connect our practices, employee commitment, customer satisfaction and loyalty with profitability and value creation. The importance of these non-financial KPIs is illustrated by their inclusion in the Westpac service-profit chain which is a key component of the Westpac DNA."⁴⁸

If boards put too much weight on the short-term benefits of strategies and too little on their long-term consequences, they may end up backing strategies that are both irresponsible and value-destroying. The challenge for boards is to give due weight to long-term outcomes in approving strategy. This can be difficult to do if the company's shareholders are themselves overemphasising short-term performance.

Intangibles

A similar problem arises with the difficulty companies have in giving due weight to intangible assets. The problem with market failure is that the benefits are financial (increased revenues and lower costs), but the costs are intangible (erosion of customer loyalty, employee commitment, and reputation). If boards evaluate strategy in purely financial terms, the intangible costs of irresponsible behaviour may not receive enough weight. Boards may, again, end up approving strategies that are both irresponsible and value-destroying.

Companies often act irresponsibly because of short-termism and failure to give weight to intangible assets.



One way that many companies have chosen to respond to this problem is to map all the factors – tangible and intangible – necessary for a strategy to succeed over the long-term, and to measure them in a 'balanced scorecard'. This can help give correct weight to valuing intangible assets in strategic decision-making.

Boards should approve strategies that create value over the long-term and in broad terms, both tangible and intangible.

The issues of short-termism and intangible value also raise questions for the design of the company's performance management system. We will return to this in Section 4.

4. INTERNAL INCENTIVES

Undesirable incentives are not limited to the external environment, they can also arise within companies. Sometimes the root cause of internal incentives problems is external market failure, but companies' performance management and reward systems can also create unintentional pressures and temptations for staff to behave irresponsibly in the absence of market failure.

Problems at the front-line...

To illustrate the problem consider the example quoted in Section 3 of a company that operates in a market where products are complicated and hard to understand and customers can be relatively ignorant. If the company pays sales people large bonuses for meeting sales targets, some may be tempted to deceive customers about the merits of products in order to increase sales. This is not merely a theoretical issue. As the UK's Financial Services Authority recently said: "we have seen cases of firms across the retail financial services markets developing...reward systems which incentivise the sales force to meet volume targets without measuring the suitability and the quality of those sales. In the worst cases, such shortcomings have led to major cases of mis-selling, most recently of precipice bonds and split capital investment trusts."⁴⁹

...reflect problems higher up

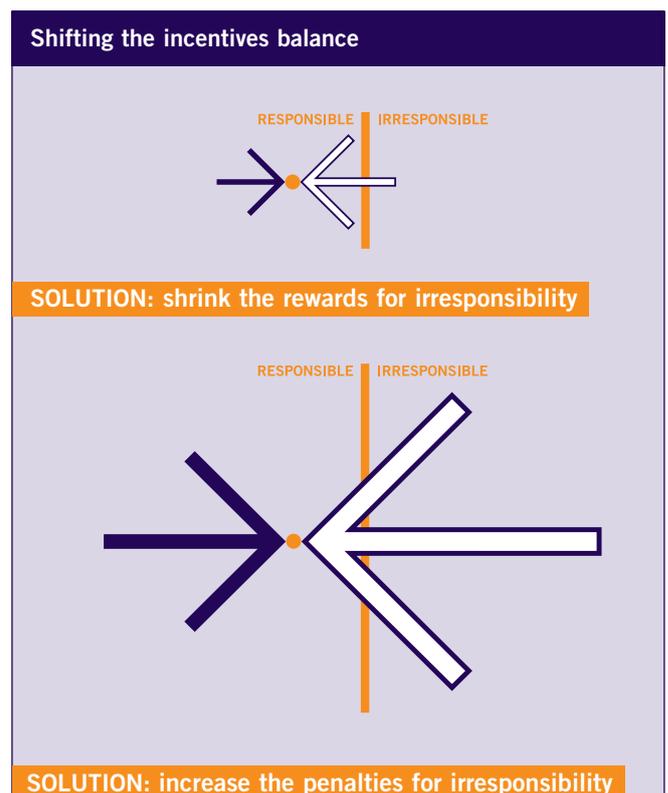
The problem illustrated by this example is not solely or even primarily about the rewards for front-line sales people. It is about the incentives for the entire business. It involves:

- sales managers and directors who are responsible for setting sales objectives and designing incentives
- marketing managers and directors who design the products must choose whether to design or approve simpler or more complex products, with opaque or transparent charging structures
- advertising executives who make choices about how forthright or otherwise the advertising copy is
- compliance and risk staff whose must decide how close to the regulatory boundaries they are prepared to operate
- customer service managers who have choices about whether to deal with complaints promptly and in good faith, or reluctantly and uncooperatively

Ultimately, these people all report to the executive management team and to the CEO. The executive management team decides operational objectives, defines measures of success or failure, and sets the basis on which bonuses are paid. It also signals desired behaviour in more subtle ways: through expressions of approval and disapproval; in recognising future leaders; and through decisions about who gets promoted or removed.

The executive team does not operate in a vacuum. It acts in the context of the board's strategy, policies and controls, and the objectives and performance-related remuneration targets set by the board. So in the end the board's decisions shape the incentives for the whole organisation, and determine whether or not virtue – or its opposite – will be rewarded; hence our earlier assertion that the board is at the apex of the company's internal incentive structure.

To ensure the company behaves responsibly, there are two complementary approaches. Either boards should reduce or remove internally generated pressures and temptations to act wrongly, or they should buttress people's commitment to resist them.



4.1 Performance management

The performance management system is the primary source of problematic internal incentives. Boards, and specifically, the remuneration committee of the board, control the rewards for the CEO and executive management team through performance-based incentive schemes. The objectives defined in these systems, the metrics used to assess performance, and the targets defined incentivise executive decisions but also cascade down lines of management, affecting priorities throughout the organisation. If these incentive systems pay no regard to the suitability of the means by which objectives are achieved they risk creating incentives for unethical behaviour.

Short-termism and problems in giving sufficient weight to intangible factors are also relevant for performance management. If too much focus is given to short-term performance, people will not care as much about the long-term consequences of their actions. If emphasis is solely on achieving financial goals, people may ignore crucial intangible factors such as customer satisfaction or employee morale. The principal value of corporate responsibility for a company's shareholders accrues over the long-term and through intangible value drivers. Over-emphasis on narrow financial factors can discourage responsible behaviour and destroy long-term shareholder value.

The board should create incentives that give weight to long-term success, intangible value creation, and are contingent on meeting accepted standards of responsibility.

CASE STUDY: INCENTIVES PROMOTING LONG-TERM DRIVERS OF VALUE THROUGH PERFORMANCE MANAGEMENT ⁵⁰

A number of companies are beginning to see the value of including non-financial metrics within executive remuneration packages, in order to ensure long-term value growth. Such remuneration systems provide executive incentives focused not just on financial performance, but also on the means by which that performance is achieved. Examples of non-financial value drivers have included levels of customer satisfaction, employee issues such as diversity and satisfaction and health, safety and environmental performance.

The boards of BHP Billiton and BT reward long-term responsible value growth by linking executive remuneration to both financial and non-financial metrics.

BHP Billiton

The BHP Billiton Group Scorecard applies to all Executive Committee members and incorporates specific health, safety, environment and people KPIs. These measures account for a minimum of 10% of the Scorecard. The figure is higher for individuals with specific responsibilities in these areas at Group level and within individual businesses. In addition a combination of lagging and leading indicators is used. The level of environmental incidents and safety figures are used as lagging indicators, and implementation of action plans to improve performance as leading indicators.

The Scorecard determines the executive annual bonus level and financial and extra-financial performance are treated independently. There is no formal requirement to achieve a specified level of financial performance before extra-financials can be taken into account in the bonus calculation. However, the Remuneration Committee has

the discretion to reduce overall awards if financial targets have not been achieved. 50% of the actual annual bonus achieved is paid out in cash immediately. The other 50% is converted into deferred shares and/or options, which vest after two years.

The extra-financial KPIs therefore play a direct part in determining the scale of awards under long-term incentive schemes, and thus the level of ultimate variable reward.

BT

In 2004, BT included reduction in customer dissatisfaction in the Corporate Scorecard to determine senior executives' annual bonus. Improving customer satisfaction is one of the company's eight strategic priorities. The weighting allocated to this area is 20%. The other factors used are Earnings Per Share, EPS (40%) and free cash flow (40%). Customer satisfaction is measured through independent monthly surveys by four major independent research agencies of residential, small business and large corporate customers. This reflects customer perceptions of BT over the preceding 12-24 months. BT has conducted research which shows a correlation between customer satisfaction, employee satisfaction and the company's image and reputation on corporate social responsibility issues. BT has a number of other extra-financial KPIs that are used to manage the business, but these are not currently included in the Corporate Scorecard.

Awards of BT shares under the Deferred Bonus Plan are linked to the value of annual bonuses – and therefore to performance on customer satisfaction. Awards are generally 50% of the executive's gross annual bonus (except in the case of the Chief Executive, whose award was 100% of bonus in 2003), and vest after three years if the executive is still employed by the company and with no further performance conditions.

Incentives below the board

The pay of executive directors is particularly significant given their power over the business, but the same principles apply throughout the company. Undesirable internal incentives for staff can cause problems not just in the sales process, but with health and safety, environmental breaches, bribery and corruption issues, and purchasing (see box below). In this example, a more balanced reward structure for sales people – taking account of the quality of sales, customer satisfaction levels, and persistency rates – shows how companies can make it easier for staff to behave responsibly. Several financial services companies now implement such systems.

While boards typically do not have a direct role in setting incentives below the executive level, **the board should**

MISALIGNED INCENTIVES IN SOURCING AND PURCHASING

The sourcing and purchasing of products ('buying') is a critical function in retail. Buyers must strike the right balance of quality and price, fashion and function to ensure that their products are preferred by consumers. Often recruited young and trained in-house, buyers tend to be offered significant performance bonuses and move frequently between roles.

The simplest and easiest way to reward buyers is according to their buying margin – the difference between the purchase and retail price of the product. This is an attractive metric, since it rewards buyers who can negotiate a low price with suppliers while keeping retail prices high by selecting attractive products. But as with all single metrics, it has drawbacks. A recent study⁵¹ of UK retail companies, found that heavily incentivised buyers often put extreme pressure on suppliers to meet cost and production targets, with the result that some suppliers compromised on ethical and quality standards during manufacture. Further, it found that these compromises often produced hidden long-term costs for the retailers themselves: cases were found where customer complaints or returns had risen, or where products had to be recalled. By the time these effects had become apparent, buyers had usually received their bonus, and often had moved on to a different role, escaping any penalties. The study concluded that many retailers would benefit from a much more balanced approach to remunerating buyers, charging back the costs of handling customer complaints, product recalls and other corrective actions against their buying margin. The retailers welcomed the results and the Ethical Trading Initiative is undertaking a collaborative project to look for best practice.

ensure the company's risk management system reviews remuneration-driven risks of improper behaviour.

Non-financial incentives

In understanding what can go wrong with performance management, it is a mistake to think only about financial rewards. People are also motivated by power, status, approval and recognition, and the intrinsic value of their activities.⁵² The board should consider these other factors in ensuring the executive and staff are motivated to behave responsibly. How the board and, in turn, the executive define, measure, and recognise success is therefore important. If the board's focus is too narrow or too short-term, or it ignores the legitimacy of the means by which success is achieved, it risks creating rewards for irresponsibility. **Boards should ensure that they give due weight to long-term and intangible factors, and corporate responsibility standards in the way the company defines, measures and recognises success.**

4.2 A culture of integrity

Sticks as well as carrots

It can be hard to avoid creating temptations and pressures to behave irresponsibly. With market failure, straightforward systems for rewarding profit can automatically create incentives to act wrongly. But removing these incentives entirely may undermine performance. While performance management systems can be aligned with corporate responsibility to some degree, too much complexity obscures the link between performance and reward. Boards should therefore not focus simply on removing temptations, but also encourage people to resist them when they arise.

Individual attitudes

There is evidence that many people, because of their personal values, will behave responsibly, even in the face of financial incentives to the contrary (see box on Moral Sanctions p14.)⁵³ **Boards can reinforce and develop this by fostering a culture in which responsible behaviour is expected and lapses are noticed, criticised, and punished with appropriate sanctions.**

There is also evidence⁵⁴ that moral commitment varies across the population. Some people are more willing to do the right thing than others, and there are some 'bad apples'. Corporate responsibility depends partly on recruiting people with a commitment to integrity, particularly in senior roles. **The board, and the nominations committee in particular, should assess integrity and character in the appointment and retention of directors.**

Employees' basic inclination to behave responsibly can be undermined through ambiguous or contradictory

standards. If people are confused about where to draw the line between right and wrong, they are more likely to step over it. A key reason for the board to state explicit corporate responsibility principles (see Section 2.2), is to remove potential for confusion. To this end **boards should ensure that corporate responsibility principles are communicated effectively to managers and staff.** This does not simply mean an ‘all staff’ email; corporate responsibility should be part of routine induction and management and staff training programmes. The principles should be supported with real examples of the pressures and temptations staff may face and the responses that are expected of them. The consequences of non-compliance (harm to others, damage to the company’s long-term interests and so on) should be explained. Finally, the sanctions for acting irresponsibly should be spelled out. The more that people willingly endorse the company’s corporate

responsibility standards and commit to adhering to them, the greater their resolve will be in the face of temptation.

Shared expectations

Whether or not people behave responsibly in the face of temptation is not just a function of their personal commitment to principles, it also depends on their beliefs about the attitudes of their colleagues. People are more likely to resist temptation if they expect their colleagues to do so to, and even more so if they expect their colleagues to enforce any lapses (through disapproval, criticism, loss of respect and trust, or more formal sanctions). The ability to resist temptation and pressure is therefore a function of corporate culture.

To foster a culture of integrity, boards need to lead by example and set the right tone at the top. If the board

CASE STUDY: REINFORCING STANDARDS THROUGH CULTURE

GSK embeds corporate responsibility standards in its culture by: setting clear expectations for individual responsibility, embedding ethical behaviour in line management responsibilities, and enforcing its standards rigorously.

GSK has a commitment to operating to the highest ethical standards at all times. But it operates in an industry in which there can be strong external pressures for managers and staff to do otherwise. A major part of GSK’s approach to this problem is to embed corporate responsibility in its culture.

This starts with GSK’s basic values statement: ‘performance with integrity’ is an essential part of the ‘GSK Spirit’. The board has set out the company’s Corporate Responsibility Principles as well as a detailed code of ethical business conduct. Employees are expected to follow the letter and the spirit of this code – even when doing so ‘can appear to sacrifice some immediate advantage.’⁵⁵ Employees also have an explicit responsibility to raise concerns about any possible misconduct by others, either through line management, an appropriate function, or through GSK’s anonymous Integrity Helpline.

GSK has an extensive internal control framework for corporate responsibility supported by a Corporate Ethics and Compliance function, and specialist compliance officers for different operational business areas. However, GSK puts a primary emphasis on the responsibility of every employee and manager to act ethically.

Managers are expected to be role models for employees by visibly demonstrating support for company standards

and encouraging adherence to them. Over 9,000 senior and middle managers undergo an annual ethics certification process that requires them to attest to having read and understood the ethics code, to ensure their staff understand its requirements, and to report any actual or suspected breaches. Business unit managers are required to complete a more extensive annual Self-Assessment Questionnaire, managed by Internal Audit.

There is widespread ethics training for staff, including induction training for new employees and targeted training on particular risk areas, such as marketing. Training includes worked examples of relevant ethical dilemmas, and guidance on appropriate responses. Managers are responsible for ensuring staff receive this training.

It is made clear to staff that non-adherence with the code of ethics will result in disciplinary action, up to and including dismissal. Managers who ignore or culpably fail to detect misconduct will also face disciplinary action. Disciplinary action is not an idle threat. In 2004 there were 954 disciplinary actions taken as a result of investigations into allegations of misconduct. This included 256 dismissals and separations. Other disciplinary actions included verbal and written warnings, and in some cases, financial penalties. Employees staying with the company received re-training and increased monitoring.

Collectively these mechanisms help to ensure that the values and standards established by GSK’s board are reflected in the attitudes and behaviours that constitute its corporate culture.

and executive act responsibly (and are seen to act responsibly), in their own decisions and actions, and in their responses to the actions of others, staff will believe the company is serious in its commitment. If on the other hand, the board's own decisions seem to lack integrity, and it appears to tolerate questionable behaviour by management, it will be hard to create the desired culture.

Boards should meet their own standards and values in their decisions, and ensure that others do so.

Similarly, lower down the organisation, if managers and staff see that breaches of corporate responsibility principles are noticed and attract sanctions, they are

more likely to act responsibly themselves. **Boards should ensure there are appropriate sanctions for irresponsible behaviour.** The visibility of sanctions is important, as well as their existence. For obvious reasons, companies tend not to give much visibility to the enforcement of their sanctions and the dismissal of staff. But this can weaken their effectiveness. Several companies now publish the numbers of staff who have been removed from their posts for breaching corporate responsibility standards.

Managers and staff should not only adhere to the company's corporate responsibility principles, but they should be expected to enforce the principles and report

CASE STUDY: CORPORATE RESPONSIBILITY AND INTERNAL AUDIT AT GUS

GUS plc makes explicit use of the group's internal audit function to investigate corporate responsibility matters, supporting its cross-group risk management process.

GUS plc is a highly decentralised group comprising Experian, Argos Retail Group (including Homebase and Argos) and a majority shareholding in Burberry. The businesses are very different: each faces different corporate responsibility challenges, has a distinctive culture and has developed a tailored management approach to corporate responsibility. Each has a strong management team. The challenge for the GUS board has been to develop robust internal control mechanisms, whilst ensuring the business management teams take ownership of relevant issues.

GUS' answer is a structured approach initiated by an annual risk review conducted wholly by the group businesses. The group head of risk assurance starts the process with the distribution of the *Group Standards for Risk Identification, Assessment and Reporting* to the management teams in the businesses, who perform their own review using whatever method they deem appropriate. The *Group Standards*, however, impose some measure of consistency, setting out the types of financial and non-financial risk to be considered (and providing examples of each) and establishing standard scales for quantifying the likelihood and impact.

The results of the businesses' risk assessments are then consolidated for reporting to the audit committee and the board, which highlights any individual risk above a specified threshold. Risks below this threshold are grouped into categories as defined in the *Group Standards*, and the total assessed impact of the category is reported. The report is presented graphically as a 'risk map' to bring out the important messages as concisely as possible.

The next stage is to link the risks to control mechanisms. GUS' internal audit function is organised

to reflect the structure of the group. Each team produces its own annual audit plan, concentrating on providing assurance over the controls relating to the largest risks. These plans are compared against the risk map to provide the audit committee with the confidence that the principal risks have been adequately covered. The risk map, with links to the audit plans, are formally reviewed and updated at the half year.

Finally, to provide additional assurance over its management of corporate responsibility-related risks, the group has developed a number of formal links between corporate responsibility and the work of the internal audit function. Two audits are reserved each year in the audit plans of every audit team for corporate responsibility-related work. This audit can take the form of either a simultaneous group-wide exercise, working to common terms of reference set by the GUS corporate responsibility management group, or an individual audit (requested by the corporate responsibility management group) in one group company.

Group-wide audits are used to assure the controls on risks that might not seem significant at the business level, but become so when multiplied across the group. An example of this type of audit was a group-wide review of the controls in place on environmental issues; a topic that may not be significant for every business, but becomes so when aggregated across the group.

The individual audit is intended for topics that the corporate responsibility management group, with its slightly different perspective, might rate as meriting review. These may relate to evolving issues that have been pointed out by stakeholders or to matters that have the potential to affect directly the reputation of the group.

The results of all internal audits go through a formal review process. They start with the local management teams and end with the relevant executive directors and audit committee of the GUS board, providing centralised oversight of a very decentralised process.

breaches. There is evidence that ‘second order’ principles requiring people to enforce first order principles are important in creating a culture in which principles are respected.⁵⁶ Staff and managers who turn a blind eye to unethical conduct should themselves be subject to sanctions.

The existence of anonymous help-lines and strong and well-understood protections for whistle-blowers will further encourage such peer-to-peer policing.

4.3 Internal control

Every large company has formal monitoring systems and audit procedures, and these are also important for identifying risks and discouraging wrong-doing. The existence of strong internal audit and regulatory compliance functions provides an extra layer of security beyond embedding corporate responsibility in the corporate culture. The Combined Code gives boards a strong role in reviewing the effectiveness of internal control, and the Turnbull Guidance is clear that the system of internal control should not be limited to risks to financial assets. By specifically referring to probity, reputation, environment and safety the Guidance makes clear the importance of corporate responsibility-related risks. The board should review and test its system of control, ensuring it is effective at identifying and managing these issues. **The board should ensure corporate responsibility risks are formally included in the company’s risk assessment procedures.**

Audit and risk

There are two dimensions to internal control: audit and risk. **The board should ensure the internal control system audits adherence to the company’s corporate responsibility standards, as well as any legal and regulatory requirements.** The system should also identify and evaluate risks of non-compliance with the company’s standards. Boards should consider whether the right information is available to judge the full range of possible failings: does the company review customer complaints; regulatory investigations; accident rates; internal whistle-blowing; and NGO and consumer campaigns? Often these non-financial measures are far less robust or comprehensive than the financial data the company collects. In these cases the board should test whether the information is supported by appropriate assurance and audit, whether it is reviewed by appropriate senior personnel and – as the ultimate test of its relevance – whether action is taken as a result.

A moving target

Corporate responsibility risks are not simply a matter of meeting the company’s own standards or those set by

existing regulation, but is also a function of the expectations and perceptions of stakeholders. As we argued in Section 1, corporate responsibility is based on widely accepted and fairly stable basic principles, so establishing these in the company’s policies and culture will serve as a reliable compass. However, new technologies, new problems and concerns, and changes in public opinion mean the risks companies face from corporate responsibility can change over time. The concerns of stakeholders – including campaigning groups – can provide a useful radar for emerging issues since many issues often start as a fringe campaign before media attention makes them mainstream. **Boards should ensure the company understands the expectations of its stakeholders about corporate responsibility, and their perceptions of its behaviour.**

5. BOARD STRUCTURE, REPORTING AND THE DUTIES OF OTHERS

5.1 Board structure

The role of board committees

The board should ensure that its structures properly support its governance of corporate responsibility. Many of the tasks described so far are for the board as a whole. The major questions of business strategy and regulatory policy in response to market failure can only be decided by the whole board. Similarly, the approval of the company's standards and values is something the board cannot sensibly delegate. On the other hand, many of the board's tasks fit naturally within the remits of existing standard board committees.

It is the remuneration committee's job to ensure – to the extent possible – that executive pay is aligned and not in conflict with corporate responsibility. The remuneration committee may also review the remuneration policy for executives at the level below the board to consider whether it is creating undesirable incentives.

In recommending candidates for directorships to the board, **it is the nominations committee's role to ensure that due weight is given to character and integrity;** and that this is reflected in the specification for the role, and in briefings to executive search consultants.

It is the audit committee's role to review the company's system of internal control to ensure that it adequately identifies and manages corporate responsibility-related risks. The audit committee may also consider whether the company's internal audit procedures are effective at monitoring adherence to the company's standards and values.

Corporate responsibility committees

In recent years, many companies have created special committees of the board to look at corporate responsibility, while others have appointed individual executives with responsibility for overseeing all or part of the corporate responsibility agenda. Such delegation is valuable because corporate responsibility issues are

CASE STUDY: THE RISK AND RESPONSIBILITY COMMITTEE AT NATIONAL GRID

For National Grid (NG), corporate responsibility is not an end in itself. The focus is on how the company can improve both its financial and non-financial performance across its business. It is also an explicit part of securing an ongoing licence from its regulator to transmit mains gas and high-voltage electricity in its home territory of the UK and elsewhere in the world. The regulatory review and approval process is complex and comprehensive, and is directly affected by non-financial matters such as reliability, customer service and – ultimately – the company's reputation with stakeholders. The group's board is keenly aware that sustained failure in any of these areas could well have a huge economic impact for the country as a whole. The reward structure in NG's external market imposes a huge penalty on irresponsible behaviour balanced by incentives for responsible behaviour. The challenge for NG's board is to ensure that the internal incentive and control structure delivers responsible behaviour.

These issues are therefore part of the full board agenda; for example the NG board begins every meeting with a formal review of health, safety and environment. However, the board has also developed a separate and influential subcommittee – the Risk and Responsibility (R&R) Committee – to provide an in-depth review of internal controls. Working alongside the Audit Committee, which

it advises on non-financial risks, the R&R Committee is formally comprised solely of three non-executive directors enabling it to maintain a degree of independence. The Group Chief Executive, Group CR Director and Company Secretary are expected to attend meetings in an invited capacity, accompanied by a small number of external advisors. The Committee has a number of responsibilities including taking the lead role on assessing the Group's non-financial risks. It works closely with the Audit Committee to ensure the risks contained within the company's register are reviewed, and a specific named executive director is responsible for each risk.

The R&R Committee receives information in a number of complementary ways. The Group's annual report into health, safety and environment is independently audited, and the auditors take the opportunity to present an independent management report to the Committee. It also takes regular reports from the Group's CR management function, and has access to independent experts. Each quarterly meeting includes a presentation from one of the Group's executives, who explains how their part of the business is managed. This is not a CR presentation; the intent is to examine how risks and responsibilities are integrated into ordinary operations. NG is at pains to stress that whilst the remit of the R&R Committee includes CR matters, it also encompasses elements of the board's core risk oversight role.

complicated and may need more time than is available at meetings of the board or the audit committee.

However, special-purpose committees have their limits. Many of the most important aspects of corporate responsibility must be considered by the board as a whole, and others naturally fall within the remit of existing board committees. It would be a mistake to see delegation to a special corporate responsibility committee to be the principal means by which the board fulfils its duty in this area.

Further, if delegation to a special committee is to be effective, particular care is needed to ensure that the division of labour between this committee and others is clearly set out in the terms of reference. Most importantly, the boundary between the oversight role of the corporate responsibility committee and that of the audit committee should be clearly drawn. The independent oversight of corporate responsibility by non-executive directors should not be allowed to fall between these two stools.

The limits of executive delegation

The limits of delegation are even more pronounced in cases where boards have delegated the topic of corporate responsibility entirely to the CEO or another executive director. Obviously implementation of most of the board's decisions on matters of corporate responsibility will be delegated to executive directors. But it is one thing to delegate responsibility for implementing the board's decisions and quite another to delegate to an executive the power to make decisions on behalf of the board. Given the conflicts of interest involved, the board must reserve for itself the role of approving the company's standards and values and providing the necessary oversight to ensure that they are met. This should not be delegated to executives. **To make this clear, corporate responsibility should be included in the list of matters reserved for the board.**⁵⁷

The role of different directors

Just as different committees have different corporate responsibility tasks, different categories of directors also have special roles to play.

The independence of non-executive directors gives them a particular role in ensuring probity in the face of conflicts of interest. The pressures and temptations in business routinely give rise to conflicts for executive management, so independent-minded non-executives are particularly important in ensuring corporate responsibility.

The chairman has an overall role in ensuring the board does its job effectively. In the board's regular review of its effectiveness, the chairman should ensure the board

reviews its effectiveness in ensuring corporate responsibility. Is the company meeting its own standards? Is it meeting external standards? Could the board do more to ensure that it meets them in future? Are the board committees functioning as they should? It is also the chairman's role to ensure the board receives the necessary information to understand and assess the nature of the company's responsibilities and its performance in meeting them.⁵⁸ Further, as the Higgs guidance in the Combined Code suggests, the chairman has a particular role in ensuring the individual board directors are meeting correct standards of probity in their individual actions and contribution to the board.

Individual board directors have a duty to adhere to the highest standards of integrity in carrying out their roles, and to make known any concerns about unethical behaviour to the chairman or the board as a whole.

This report has focused on the governance role of the board as a whole, and so has not made explicit recommendations about how the executives should 'manage' corporate responsibility. This should, of course, not be taken to imply no role for the executives. On the contrary, the board delegates authority for running the business to the chief executive, so most of the actions described in this report will, in practice, be dealt with by the executive directors. Boards should both support their chief executives in fulfilling this heavy burden and hold them accountable for doing so effectively.

Finally, the company secretary also has an important part to play in the governance of corporate responsibility. Often the company secretary is seen as the keeper of the company's conscience, drawing attention to any proposals which are illegal or unethical. With the 2003 revisions to the Combined Code, company secretaries have been given a more explicit role in advising the board on governance. In the light of the recommendations in this report, this could be interpreted to give company secretaries a general role of advising board's in their governance of corporate responsibility.

5.2 Reporting

The Operating and Financial Review

There are three reasons the board should report on the company's approach to and performance on corporate responsibility. First, it is important the shareholders understand the relationship between corporate responsibility and the company's strategy. Success or failure at meeting corporate responsibility principles can have a material affect on the future prospects of a business: affecting its relationships with customers, employees and others; determining the value of brand equity and other intangible assets; and creating legal liabilities.

The new Operating and Financial Review (OFR) requires companies to provide shareholders with the information necessary to understand the company's strategy and prospects, making reference to risks, resources, relationships, and to social, employee and environmental issues, where relevant.⁵⁹ In the OFR the board should report on corporate responsibility, to the extent necessary for shareholders to understand the company's strategy, risks, resources or relationships.

It is worth noting the OFR is a report for shareholders about strategically relevant issues, so it should not contain information that is not, in the board's view, strategically relevant. Such issues should be contained elsewhere in the annual report – perhaps in the company's governance reporting – or in a separate corporate responsibility report. On the other hand, where corporate responsibility is strategically important, a clear account in the OFR may enable investors to give more weight to the risks associated with irresponsibility and the contribution of responsible behaviour to intangible assets and long-term success. This could, in turn, help to reward responsible companies with higher share prices, and reduce the pressures and temptations for improper behaviour.

Governance and remuneration reports

The second reason for clear reporting is that shareholders have an interest and a role⁶⁰ in monitoring the board's effectiveness at governing the company, as well as an opportunity to vote on the remuneration report. Understanding the board's approach to corporate responsibility is an important aspect of both. Therefore, the board's report on corporate governance should include an account of the board's approach to the governance of corporate responsibility, including how it meets the Combined Code requirement to set the values and standards for the business and ensure the company meets its obligations to shareholders and others.

Similarly, the board's remuneration report should include information about how, if at all, long-term, intangible, and corporate responsibility factors are incorporated in the remuneration framework. This is important if the board's remuneration and performance management framework for executive directors has a strong influence on shaping the incentives for responsible behaviour. A recent report⁶¹ by two large institutional investors, Hendersons Global Investors and the Universities Superannuation Scheme, suggests that corporate reporting on this aspect of remuneration is not currently of a high enough quality.

The duty of accountability

There is a third reason boards should report on corporate responsibility. A basic part of the corporate responsibility contract is that companies make themselves accountable

to those their actions affect. Ensuring the company is publicly accountable for its behaviour is therefore a key role for boards in fulfilling the company's side of the contract. One element of accountability is the publication of a corporate responsibility report explaining the company's understanding of its responsibilities, its approach to meeting them and the extent of its success.

The board should approve and issue a regular corporate responsibility report. While the board does not have a statutory responsibility to produce corporate responsibility reports, it is an important means for the company to fulfil its responsibility to be accountable. Such reports are not the only means of achieving accountability – dialogue and consultation with stakeholders and their representatives is another.⁶²

Reporting on corporate responsibility is at an early stage in its development and there is a considerable difference between the best and worst reports. Efforts are underway to define principles of good reporting.⁶³ Unlike the annual report and accounts, there are no legal standards for verification of non-financial reporting, nor is there yet a consensus on the organisations best suited to provide such assurance. As a result there is wide variation in the nature and scope of such assurance, and many companies choose not to pursue it at all. Ultimately, the board must judge whether its process for reporting provides an accurate and fair account on this topic.

5.3 The responsibilities of others

Board directors are not the only ones with a role in corporate responsibility. Employees, investors, customers, governments, regulators, lobbyists, trade associations, trades unions, bankers, stockbrokers, auditors, lawyers, journalists, pressure groups and others have important roles in enabling companies to behave responsibly. Boards are by no means alone in facing this challenge.

Employee responsibility

Many aspects of corporate responsibility raise issues of individual responsibility for managers and employees. Whatever the pressures or temptations, individuals do have a choice about whether to behave responsibly or not. While there is much that board directors can do to remove unhelpful incentives, inform employees about their duties, and in various ways act to bolster their ethical resolve, ultimately managers and staff must decide how they will act.

This is a challenge for individuals, but it is also a challenge for the various professional bodies that define and inculcate professional standards. Accountants, internal auditors, HR professionals, marketers, advertisers, salespeople, managers, risk managers

and IT professionals all have professional bodies that share – with companies – a responsibility for ensuring that their members understand and adhere to the relevant ethical principles that relate to their profession. Many professional bodies have defined codes of ethics relating to their profession and have begun to incorporate them in training and professional accreditation.

Investor responsibility

A company's investors also have an important role to play. They are a major source of pressure on executive management and boards: through their influence on the share price, the power of their votes, and through their regular meetings with management they can exert a powerful force on the actions of the company. However, as several board directors made clear during the writing of this report, investor pressure often makes it harder and not easier for boards to deliver corporate responsibility.

There is a fundamental problem here. A basic characteristic of market failures that are the cause of many corporate responsibility problems is that they pit the interests of investors against those of wider society, at least in the short-term. This means that boards are placed in the uncomfortable position of having to respond to the demands of impatient investors while seeking to fulfil their obligations to others. If market failures are not corrected through self-regulation or government intervention, tensions between value-creation and corporate responsibility will persist (see scenario 3 in chart, Section 3.5).

This problem is often a matter of time horizons. As we have argued (Section 3.5), the benefits of exploiting market failure are often more apparent than real. Once you take account of the risks of regulatory sanctions, litigation, and public disapproval the sustained benefit for investors disappears. If investors give due weight to the long-term (and intangible) value of responsible behaviour, they will avoid causing unhelpful pressures. But if investors fail to do so, the share price will not reflect this underlying reality. Some investors have committed to working on this problem.⁶⁴ The long-running debate about City short-termism signals underlying problems in the way investment managers are themselves incentivised and the design of the mandates awarded by pension funds and other asset owners. These problems make progress difficult.⁶⁵

Shareholders also have another role to play; they can offer support and encouragement to boards in their effort to ensure companies behave responsibly. If there is a contract between companies and society, it is a contract that company shareholders must also honour. The privileges society confers on companies are of great benefit to shareholders – limited liability, above all. Shareholders are members and owners of companies

and as such must play their part in the bargain. The idea of 'investor responsibility' is a necessary complement to corporate responsibility.

Investors – particularly those with a large holding in a company – have a duty to actively support and encourage their directors to exercise effective governance, both to create long-term value for the shareholders, but also to meet corporate responsibility obligations.⁶⁶ Several large institutional investors have acknowledged the idea of investor responsibility in recent years and a number of initiatives are underway to give force to this idea.⁶⁷ For example, the influential UK Institutional Shareholders Committee has included corporate responsibility as one of the items that shareholders should raise with companies as part of their governance activism.

Customer responsibility

A company's customers – whether individual or corporate – also have an important role to play in resolving corporate responsibility problems. Sometimes markets deliver socially undesirable outcomes because consumers fail to take sufficient responsibility for the consequences of their market choices. For example, a significant proportion of global carbon emissions arise not from companies, but from the choices of consumers. If customers prefer gas-guzzling sports-utility vehicles over the much more efficient alternatives marketed by car companies, it is wrong to lay all the blame for climate change on the car manufacturers or the oil companies that provide the fuel.

If consumers took responsibility for the externalities associated with the production and use of the products they buy, they would cure an important source of market failure, giving companies incentives to create more environmentally and socially benign products. In order to achieve the goals of sustainable development, corporate responsibility must be complemented by individual responsibility.

And it is not just externalities that customers have responsibilities for. Market failures associated with information problems often arise, in part, because customers fail to take sufficient care to inform themselves of the risks associated with the products they purchase. The principle of *caveat emptor* continues to have its place.

CONCLUSION

Misaligned incentives are a major cause of the problem

Companies often behave irresponsibly because markets and organisations create pressures and temptations that lead them to do so. Various structural problems associated with market failure create incentives for the company as a whole to act irresponsibly, and flawed internal incentives create temptations for executives and staff to do so. This is not the only reason companies behave irresponsibly, but it is the most important one.

Boards are at the apex of the incentive structure

Boards have an important role to play in responding to and shaping these incentives. They can do so because of their position at the apex of the incentive structures within companies – at the junction between market and organisational incentives. This position gives them considerable power to remove or change undesirable incentives. At the market level, this power is exercised through board decisions about strategy; about the design of the business model; and about the company's approach to regulation (whether according to voluntary standards or by means of government intervention). At the organisational level, the board's power to shape incentives is more direct. It is exercised through the design of the performance management frameworks, including executive remuneration; through the setting of standards and values; through their leadership and example, and through enforcement.

Carrots and sticks

The common theme is that effective board action on corporate responsibility is about either removing harmful incentives or creating positive counter-incentives by, for example, either changing the design of the business model, the remuneration policy, or establishing and enforcing market or internal standards. In both cases the incentives may be either financial or non-financial (i.e. recognition, reputation and other intangibles). The essential idea is to set things up so that responsible behaviour – virtue – is rewarded.

The power of ethical norms and values

Policy makers and boards have long seen the alignment of incentives as a central challenge. Our approach is distinctive in the emphasis it gives to the power of ethical norms and values in motivating behaviour. When it comes

to meeting and enforcing the corporate responsibility contract, ethical norms and values are possibly the most powerful force at work (see p14). Harmful exploitation of market failure is likely to be perceived as irresponsible and so to incur the disapproval of customers, staff and business partners, and may lead to their rejection of the company in the marketplace. Whatever the short-term temptations to behave irresponsibly, boards should be aware the motivating power of ethical norms and values makes doing so inherently risky.

Similarly, within organisations, the motivating power of ethical norms and values means that most executives and staff are pre-disposed to behave responsibly, even in the face of financial temptations to the contrary. But the degree to which they will do so depends on the clarity of their understanding of corporate responsibility principles that should guide their behaviour, and the support they receive from the corporate culture. The board's leadership is important in achieving both.

Recommendations

Based on our analysis and research and consultation with companies we have identified several recommendations for actions boards may take to ensure companies behave responsibly.

As the case studies illustrate, these recommendations are being implemented by various company boards. This gives us some confidence in their practical value. However, we recognise the debate about effective governance of corporate responsibility is in its early stages. Our recommendations therefore warrant further thinking.

Boards have a decisive role to play in corporate responsibility. The secret to success is to ensure virtue is rewarded.

EFFECTIVE BOARD ACTION ON CORPORATE RESPONSIBILITY

Recommendations

Set values and standards

Be clear about the terms of the corporate responsibility contract, set explicit standards and values for the business.

Think strategically about corporate responsibility

Understand the problems in your markets, and design a business model that avoids them.

Be constructive about regulation

Support both self-regulation and government intervention to correct structural problems in markets.

Align performance management

Reward responsible success over the long-term, and not just meet financial targets over the short-term.

Create a culture of integrity

Set the right tone at the top and cultivate the right values in the corporate culture.

Use internal control to secure responsibility

Safeguard the company's standards with robust internal audit and control systems.

Actions by the board

State the corporate responsibility standards that guide the board's decisions and the behaviour of executive management and staff.

Ensure the standards are appropriate, comprehensive, and consistent.

Ensure that corporate responsibility principles are communicated effectively to managers and staff.

Review the risks associated with strategy, including risks of breaching corporate responsibility standards.

Seek creative strategic responses to market failure.

Approve strategies that create value over the long-term and in broad terms, both tangible and intangible.

Support voluntary self-regulatory standards, and ensure the company complies.

Ensure the company plays a constructive role in seeking efficient and effective regulatory remedies.

Give due weight to long-term and intangible factors, and corporate responsibility, in the definition, measurement and recognition of success.

In remunerating executives: balance long-term and short-term rewards; use performance metrics that reflect both tangible and intangible value creation; and make rewards contingent on responsibility.

Ensure the company's risk management system reviews remuneration-driven risks of improper behaviour.

Meet their own standards and values in their decisions, and ensure that others do so.

Give priority to personal integrity in the recruitment and retention of directors, and throughout the company.

Foster a culture in which responsible behaviour is expected and lapses are noticed, criticised, and punished with appropriate sanctions.

Ensure corporate responsibility risks are formally included in the company's risk assessment procedures.

Ensure the internal control system audits adherence to the company's corporate responsibility standards.

Understand the expectations of the company's stakeholders about corporate responsibility, and their perceptions of its behaviour.

Further suggestions

In implementing these recommendations specific board committees have particular roles to play.

The role of board committees

- It is the remuneration committee's job to ensure – to the extent possible – that executive pay is aligned and not in conflict with corporate responsibility.
- It is the nominations committee's role to ensure that due weight is given to character and integrity in recommending candidates for the board.
- Audit committees should review the company's system of internal control to ensure that it adequately identifies and manages corporate responsibility related risks and monitors adherence to the company's standards and values.

Reporting

The board should ensure the company produces accurate and timely reports on this topic. It should:

- Include in the OFR, information on corporate responsibility, to the extent necessary for shareholders to understand the company's strategy, risks, resources or relationships.
- Include in its report on corporate governance, an explanation of the board's governance of the company's corporate responsibilities.
- Include in its remuneration report, information about how, if at all, long-term, intangible, and corporate responsibility factors are incorporated in the remuneration framework.
- Approve and issue a regular corporate responsibility report.

The benefits of effective board action

Corporate responsibility sets the terms of an implicit contract between companies and their customers, employees, business partners and wider society. It is a foundation of our economic system and is enormously valuable to all parties. Corporate responsibility is based on basic ethical principles – such as honesty, acting with due care, and respecting rights – that are widely accepted by both companies and their stakeholders, and, frequently, embodied in laws and regulations.

Most of the time companies do a good job of behaving responsibly. But the incentives, pressures and temptations that we have described can push companies off course. Effective board action is vital to ensuring that this does not happen. Where boards succeed in the governance of corporate responsibility, customers, employees, and wider society will have good reason to place their trust in companies and reward them their loyalty, commitment and advocacy, with the dependable profitability that will result.

Future action

The report's three sponsors plan to put its findings to use. Insight Investment will reflect the analysis and recommendations of the report in its engagement with companies. Business in the Community will explore how to include the report's recommendations in its Corporate Responsibility Index during 2006. FTSE Group hopes this research will help identify and share best practice in the governance of corporate responsibility. The sponsors hope the report will contribute to the development of international standards and guidance in this area. We welcome comment on the analysis and recommendations contained in the report, please contact: craig.mackenzie@insightinvestment.com and patrick.mallon@bitc.org.uk.

NOTES

- 1 'Responsible Business 2004' *Financial Times*, 29 November, 2004; 'The Good Company', *The Economist*, 20 January 2005.
- 2 *The Combined Code on Corporate Governance*, Financial Reporting Council, 2003.
- 3 See for example, Cadbury, A (2002) *A Corporate Governance and Company Chairmanship*. (Oxford University Press).
- 4 *Combined Code op. cit.* Section A.1.
- 5 The proposed wording on this topic in the draft *Company Law Reform Bill* provides more detail on this (see note 28)
- 6 For a list of those who have offered their experience and comments to the project, see Appendix.
- 7 Fund managers, including Insight Investment, F&C, Henderson Global Investors, Hermes, Jupiter and Morley Fund Management, have initiated work of this kind.
- 8 The Business in the Community Corporate Responsibility Index (www.bitc.org.uk/programmes/key_initiatives/corporate_responsibility_index) and the FTSE4Good and FTSE ISS Corporate Governance indices (www.ftse.com/ftse4good.com)
- 9 Some companies' business operations contribute to these ends (e.g. making vaccines or solar panels), but their contribution is, quite properly, motivated more powerfully by the attempt to create value for their investors, than by a sense of duty. Ultimately, where no commercially viable market can be created for a socially valuable outcome, it is unlikely to be provided unless governments or philanthropists intervene. Corporate responsibility does not impose a general duty on companies' to fund such activities, when they are to the material detriment of their shareholders.
- 10 As the UK Department for Trade and Industry's CSR website puts it (October 2005) "we see CSR as the voluntary actions that business can take, over and above compliance with minimum legal requirements" (www.csr.gov.uk/whatiscsr.shtml). See also the definition used by the Commission of the European Communities (2002) *Corporate Social Responsibility: A business contribution to sustainable development*. (European Commission)
- 11 See, for example, Section 13, *Sale of Goods Act*, (1979).
- 12 The Committee of Advertising Practice (2005). *British Code of Advertising, Sales Promotion and Direct Marketing* Section 2.1.
- 13 Financial Services Authority (2005) *Handbook* Section 2.1 The Principles.
- 14 *Sex Discrimination Act 1975* and *Equal Pay Act*, 1970.
- 15 *Health and Safety at Work Act*, 1974, Section 2.(1).
- 16 However, some corporate responsibility principles are not and may never be the subject of regulation. Most philanthropic and community investment work by companies is not covered by law. Perhaps this is as it should be. Some argue that philanthropy is arguably not a moral duty of companies, but about going beyond the call of duty. Further, it is precisely because philanthropy is beyond the call of duty that it is impressive and motivates enthusiasm from employees and others.
- 17 See Schmid, A (2004) *Conflict and Cooperation: Institutional and Behavioral Economics*. Blackwell.
- 18 Hampton, P (2004) *Reducing administrative burdens: effective inspection and enforcement*. HM Treasury.
- 19 Gordon Brown, *Financial Times*, 24 May 2005.
- 20 Similarly, people can be remarkably sensitive to moral judgements of their actions. Where people feel they have acted properly – particularly in the face of temptations to do otherwise – they feel a sense of satisfaction and self-respect. If people think they have acted wrongly they will often feel guilt, discomfort and shame. It requires no great leap to see how corporate responsibility is, as a result, important to employee motivation and productivity, and how corporate responsibility failures may lead to a deterioration in employee morale, commitment and, ultimately, retention.
- 21 See Reichheld, R (2001) *The Loyalty Effect* (Harvard Business School Press) and Davies, G *et al* (2002) *Corporate Reputation and Competitiveness*. (Routledge).
- 22 It is possible that this kind of doubt is one reason why some NGOs and regulators are sceptical about corporate responsibility. They assume that business people are motivated solely by financial self-interest, and so, when push comes to shove, assume that voluntary corporate responsibility standards will be powerless. And so they call for ever more government regulation, because only regulation, they think, has the 'teeth' necessary to oppose self-interest. This doubt may also prompt the sometimes obsessive need amongst corporate responsibility practitioners to make a business case for corporate responsibility. If ethics is impotent to motivate behaviour, then the only basis on which corporate responsibility will have any power to stand up to financial self-interest is if there is a business case for it (i.e. if there is a larger hidden financial self-interest there to motivate it).

- And such doubts may discourage company boards and managers from investing much time and energy in ensuring that corporate responsibility standards are well understood by their staff. If ethics is powerless to motivate behaviour, why bother? None of these doubts are wholly without foundation. Regulatory 'teeth' and business cases have their place. However, a better understanding of the intrinsic power of ethical motivation, may allow people to put more faith in corporate responsibility as a mechanism, without the need for extrinsic props.
- 23 The experiment has been repeated hundreds of times in over 20 countries. Sometimes the sums of money have been fairly substantial – up to three months' wages. Numerous other experiments have also been conducted using different games as their basis, that also demonstrate that many people are disposed to respect moral rules in the face of financial incentives to the contrary. See Kagel, J and Roth, A (1998) *The Handbook of Experimental Economics*, and Camerer, C and Thaler, R. 'Ultimatums, Dictators and Manners,' *Journal of Economic Perspectives* 9, 2 (1995): 209-219.
- 24 Sanfey, A et al (2003) The Neural Basis of Economic Decision-Making in the Ultimatum Game. *Science*, Vol 300, Issue 5626, 1755-1758, June.
- 25 People are not prepared to bear unlimited costs in order to punish irresponsible behaviour. The experimental data show that willingness to punish declines as the price of doing so increases, but the decline is not very rapid. Many people are prepared to bear quite substantial costs to see justice done. Kagel & Roth. *op. cit.*
- 26 *Company Law Reform White Paper 2005* Department for Trade and Industry (www.dti.gov.uk/cld/WhitePaper.htm).
- 27 *Ibid.* p.20.
- 28 "In fulfilling the duty [to promote the success of the company] a director must (so far as reasonably practicable) have regard to-
- (a) the likely consequences of any decision in the long term,
 - (b) the interests of the company's employees,
 - (c) the need to foster the company's business relationships with suppliers, customers and others,
 - (d) the impact of the company's operations on the community and the environment,
 - (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
 - (f) the need to act fairly as between members of the company." *Company Law Reform Bill*, 1 November 2005.

29 'The Good Company', *The Economist*, *op. cit.*

30 One important paradox here is that too much emphasis on the idea of enlightened shareholder value and too little on the moral case for corporate responsibility may be self-defeating. Corporate responsibility mechanisms work because executives, customers, employees and other stakeholders believe that they are a moral requirement for companies and, as such, are prepared to impose sanctions on companies for irresponsible behaviour. If companies, governments, and others stop affirming the norms of corporate responsibility as moral obligations, and talk only about the 'business case' for doing the right thing, there is a risk that these norms will cease to be seen as a requirement. This in turn undermines the business case because weakening corporate responsibility norms reduces the likelihood and scale of sanctions for irresponsible behaviour. Paradoxically, too much emphasis on the business case undermines the enlightened-shareholder-value case for behaving responsibly.

31 As we made clear at the beginning of this section, corporate responsibility does not create an open-ended requirement to serve the public interest, merely a limited obligation on companies to respect the terms of the implicit corporate responsibility contract.

32 Sometimes business principles are issued by the CEO rather than the board. This is the case in BP and Vodafone. Though, in the case of BP, the board requires the CEO to comply with the principles included in its executive constraints policy (see case study).

33 EIRIS, October 2005.

34 To suggest that mis-aligned incentives are the fundamental cause of wrong-doing is not to excuse the irresponsible behaviour of those who succumb to temptation. Individuals have a duty to do the right thing whatever the pressures or temptations. However, given the imperfections of human nature, action to remove undesirable temptations and increase the penalties associated with irresponsible behaviour, has a vital role to play in ensuring corporate responsibility.

35 Generally on market failure see McMillan, J. (2002) *Reinventing the Bazaar* (London: Norton). On internal incentives problems see, Jensen, M. and Meckling, W. (1976) 'Theory of the Firm: Managerial Behavior Agency Costs and Ownership Structure', *Journal of Financial Economics* 3.4: 305-60.

36 Market failure is not the only cause of problems, though we suspect it is the major one. Ignorance and incompetence can lead to corporate responsibility, as can various kinds of regulatory failure. Furthermore, strictly speaking, economics talks about market failure in terms of sub-optimal welfare outcomes, not irresponsibility. The concept of responsibility relates to unacceptable actions not to sub-optimal outcomes. However, many of the sub-optimal outcomes associated with market failure

- also entail breaching principles of corporate responsibility (e.g. dishonesty with regard to customers, failure to take due care when externalising costs). Market failure is therefore a primary cause of corporate irresponsibility.
- 37 p.40-43 Cooter, R. and Ulen, T. (2000) *Law and Economics* (Addison Wesley Longman).
- 38 Public goods problems can be conceptualised in terms of positive externalities. Companies do not have incentives to provide public goods because they cannot exclude people from enjoying the positive externalities arising from them.
- 39 A recent US study has shown that more than 80% of executives would cut expenditures on marketing and R&D in order to meet earnings forecasts, even when they know such cuts would destroy long-term shareholder value. If they are prepared to do this, is it much of a leap to suggest that some executives may be tempted to avoid asking too many difficult questions if doing so places earnings in jeopardy? (Graham, J, Harvey, C and Rajgopal, S, "The economic implications of financial reporting," *Journal of Accounting and Economics*, January 2005 (<http://papers.ssrn.com>))
- 40 The Turnbull Guidance, *Combined Code on Corporate Governance op.cit.* p.27.
- 41 Association of British Insurers (2000) *Disclosure guidelines on socially-responsible investment.* (www.abi.org.uk/Display/File/85/SRI_Guidelines.doc)
- 42 Schmidhiney, S (1998), *Financing Change: The Financial Community, Eco-efficiency, and Sustainable Development* (MIT Press).
- 43 According to Mark Proegler, director of BP's Emissions Markets Group, quoted by *Reuters*. 29 August 2005.
- 44 Rory Sullivan (2005), *Rethinking Voluntary Approaches in Environmental Policy* (Edward Elgar, Cheltenham, UK); OECD (1999), *Voluntary Approaches for Environmental Policy: An Assessment* (OECD, Paris, France) and see Mackenzie, C. "Moral Sanctions: Ethical Norms as a Solution to Corporate Governance Problems" *Journal of Corporate Citizenship*. 15. (2004) for an alternative approach to this topic.
- 45 Krarup, S. and Ramesohl, S. (2000). *Voluntary Agreements in Energy Policy – Implementation and Efficiency* (AKF Institute of Local Government Studies, Copenhagen).
- 46 See Mackenzie, C. (2003) *Defining Global Business Principles.* (Insight Investment). (www.insightinvestment.com/responsibility)
- 47 See Lascelles, D (2005) *The Ethics of Influence.* (Institute of Business Ethics)
- 48 Westpac *Concise Annual Report 2004*
- 49 FSA (2004) *Treating customers fairly: progress and next steps.* (www.fsa.gov.uk/pubs/other/tcf_27072004.pdf).
- 50 This case study draws heavily on *Getting what you pay for.* Hendersons Global Investors/USS (2005).
- 51 Insight Investment/Acona (2004), *Buying your way into trouble.* (www.insightinvestment.com/documents/responsibility/responsible_supply_chain_management.pdf)
- 52 See for example, Frey, B (1997) *Not just for the money* (Edward Elgar); Gintis, H *et al.* (2005) *Moral Sentiments and Material Interests: The Foundations of Cooperation in Economic Life* (MIT Press).
- 53 Gintis, H *et al.* *Op. Cit.* p12
- 54 Gintis, H *et al.* *Op. Cit.* p12
- 55 *Employee guide to business conduct*, Second Edition, p.1
- 56 Axelrod, R. (1997) *The Complexity of Cooperation* (Princeton University Press)
- 57 Section A.1.1 of the *Combined Code on Corporate Governance* requires boards to publish the list of matters they reserve for themselves. *Op. Cit.*
- 58 Section A.2, *Combined Code on Corporate Governance. Op. Cit.*
- 59 The Companies Act 1985 (Operating and Financial Review and Directors' Report etc.) Regulations 2005 (www.opsi.gov.uk/si/si2005/20051011.htm)
- 60 See Section E.3 of the *Combined Code* and the Institutional Shareholder's Committee (2005) *Statement of Principles for Responsible Investment.* (www.napf.co.uk/publications/Downloads/PolicyPapers/section/2005/Comment_on_ISC_Principles.pdf)
- 61 Hendersons Global Investors and USS (2005) *Getting what you pay for.*
- 62 See Accountability AA1000 standard (www.accountability.org.uk/aa1000) for more on this.
- 63 See the Global Reporting Initiative and Accountability for guidance on this topic. Business in the Community (2005) *A Director's Guide to Corporate Responsibility Reporting*, (<http://www.bitc.org.uk/resources/publications>).
- 64 Insight, Morley, Henderson, F&C, the signatories of the Enhanced Analytics Initiative, and various stockbrokers.
- 65 Mackenzie, C (2006). Chapter 2 in Sullivan, R and Mackenzie, C *Responsible Investment.* (Greenleaf)
- 66 For a fuller discussion of the role investors can play, see Sullivan, R and Mackenzie, C (2006) *Responsible Investment.* (Greenleaf)
- 67 Initiatives include the Enhanced Analytics Initiative; the United Nations Environmental Programme, Principles in Responsible Investment; Just Pensions; the Marathon Club; the Institutional Investors Group on Climate Change; as well as a number of initiatives carried out by individual institutions such as those undertaken by Insight Investment, Henderson and F&C.

APPENDIX

We thank the following for contributing their experience and comments:

Bob Ayling, Chairman, **Holidaybreak plc**
Harry Baines, Company Secretary, **HBOS plc**
Gordon Bentley, Company Secretary, **GUS plc**
Lord Butler, Non-Executive Director, **HSBC Holdings plc**
Jeremy Booker, VP Corporate Governance, **BP plc**
Philip Bramwell, Company Secretary, **O2 plc**
Simon Bicknell, Company Secretary, **GlaxoSmithKline plc**
Julia Cleverdon, Chief Executive, **Business in the Community**
Paul Cuttill, COO of Networks, **EDF Energy plc**
Richard Ellis, Corporate Responsibility Manager, **Boots Group plc**
Sonia Fennel, Assistant Company Secretary, **Boots Group plc**
Judy Greevy, Head of Corporate Responsibility and Diversity, **Centrica plc**
Charlotte Grezo, Corporate Responsibility Manager, **Vodafone Group plc**
Sir Derek Higgs, (then) Senior Adviser, **UBS Investment Bank**
David Jones, Chairman, **Next plc**
Helen Jones, Director of Governance, **Kingfisher plc**
David Jackson, Company Secretary, **BP plc**
Julia King, Vice President, Corporate Responsibility, **GSK plc**
Rob Lake, Head of Corporate Engagement, **Henderson Global Investors**
Gareth Llewellyn, CSR Director, **National Grid plc**
Andrew McCallum, Corporate Responsibility Manager, **Centrica plc**
Mark Makepeace, Chief Executive, **FTSE Group**
Kate Nealon, Non-Executive Director, **HBOS plc**
Eric Nicoli, Chairman, **EMI Group plc**
Lord Oxburgh, (then) Chairman, **Shell Transport and Trading Co plc**
David Pearl, Assistant Company Secretary, **BP plc**
Sir Mervyn Pedelty, Director, **Business in the Community**
Steven Petit, Non-Executive Director, **National Grid plc**
Mike Rake, UK Senior Partner and International Chairman, **KPMG** and Chairman, **Business in the Community**
Angus Russell, Chief Financial Officer, **Shire Pharmaceuticals Group plc**
Martin Scicluna, Chairman, **Deloitte & Touche**
Sarah Sodeau, Group Head of Risk Assurance and CR, **GUS plc**
Lord Stevenson of Coddenham, Chairman, **HBOS plc**
Larry Stone, Company Secretary, **BT Group plc**
Matt Taylor, Corporate Responsibility Manager, **BP plc**
John Weston Smith, Chief Operating Officer, **British Land Company plc**
Charlotte Wolff, Corporate Responsibility Manager, **O2 plc**

“The Combined Code says that boards should set the values and standards of the company, and ensure that it meets its obligations to shareholders and others. This report offers some very useful suggestions about how boards should go about fulfilling this task.”

Sir Derek Higgs, Deputy Chair, Business in the Community

“This report takes a refreshingly hard-nosed approach to corporate responsibility. It explains the pressures that can blow companies off course and the rewards of getting it right. It also argues that responsible companies deserve less red tape. Regulators take note!”

Sir Digby Jones, Director General, CBI

The full version of the *Rewarding Virtue* report is available in PDF format for free or order a hard copy for £20 at:
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Insight Investment is the asset management arm of HBOS. Insight Investment has a commitment to engage with the companies in which it invests to support boards in their efforts to deliver high standards of corporate responsibility.

www.insightinvestment.com/responsibility

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