Investor Responsibility Briefing

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Insight publishes report on boards and the governance of corporate responsibility

As previously reported, Insight has been working with FTSE Group and Business in the Community (BiTC) to define more clearly the role of boards with regard to corporate responsibility. On 1 December 2005, these three organisations published a report on our research so far entitled 'Rewarding Virtue'. The report is available at: www.insightinvestment.com/responsibility/rewardingvirtue.asp. The following article summarises the report's main conclusions and recommendations.

The publication of 'Rewarding Virtue' follows a year-long programme of analysis, research and consultation with executive and non-executive directors of leading UK companies about the proper role of boards with respect to corporate responsibility. The report focuses on the governance of corporate responsibility, i.e. the direction and control of corporate responsibility, rather than on its operational management or the managing role of the executive directors.

The Combined Code on Corporate Governance makes clear that corporate responsibility is important. It says that directors should 'set the values and standards of the company and ensure that it meets its obligations to shareholders and others. The problem is, though, that the Code provides very little detail on how exactly boards are expected to exercise direction and control on this issue. It is a similar situation to the recent Company Law Reform Bill. While it includes among its list of statutory duties for directors a requirement that the interests of stakeholders, the company's social impacts and its reputation be considered in their effort to promote the success of the business, there is no concrete detail on what this actually entails.

Creating value

'Rewarding Virtue' argues that corporate responsibility is a precondition for sustainable long-term value creation.

Corporate responsibility standards are backed by a powerful system of incentives and sanctions that change the shape of markets and create material opportunities and risks for companies. These include laws, regulations, taxes and subsidies, licences and fines, as well as market-based instruments. Getting corporate responsibility wrong can be very costly – as the shareholders of Enron, Parmalat, Ahold, Merck and Compass now know.

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 and employees, not to mention among 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.

For these reasons, corporate responsibility is a fundamental ingredient of sustainable long-term business success.

Pressures and temptations

Companies have little difficulty in behaving responsibly when markets reward them for doing so. Where market incentives are poorly aligned, however, the temptation – pressures, even – to behave irresponsibly can be strong. This can lead companies, or those who work for them, to renege on their contracts with society.

Perhaps the most important source of unwelcome pressure is market failure. This creates temptations for companies to adopt short-term, irresponsible, profit-maximising strategies, and in doing so breach corporate responsibility standards. But external forces aren't alone in leading companies astray: an organisation's own culture, its objectives and performance targets, all the way down to its incentive schemes, can create pressures and temptations for executives and staff to behave irresponsibly. The obvious example is that of the salesperson who, looking to clinch that big sale to meet his or her annual target and trigger a lucrative bonus, succumbs to the temptation to deceive a customer.

Often, the benefits of behaving irresponsibly are more apparent than real, because over the long-term they are frequently 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 board's job

Effective governance from the board is essential if companies are to reap the long-term rewards for responsible behaviour and resist the pressures and temptations that might otherwise lead them astray.

Boards are in a unique position. They sit at the apex of the incentive structure for companies. Through their decisions about strategy, they drive companies' responses to the external incentives provided by the market and regulatory environment. And, through the design and implementation of remuneration and internal control systems, they shape their internal incentives.

Boards can have, in other words, a decisive role to play, both in removing unhelpful pressures and temptations, and in reinforcing the rewards and penalties that support responsible behaviour. If boards fail to play this role effectively, they run the danger of significantly increasing the risks of irresponsible corporate behaviour, particularly so when they operate within market-failure situations where pressures and temptations are likely to emerge.

As the report's recommendations indicate (see box below), boards can do this work both through decisions about strategy and interactions with regulators, and through its leadership and control of the business.

Getting the structures right

In order to deliver corporate responsibility, boards do not just have to think about strategy and control, they also have to think about the board's organisation and the roles of individual board directors and committees.

Boards should ensure that their structures properly support governance of corporate responsibility. Many of the actions for boards recommended by 'Rewarding Virtue' (see box below) are for boards as a whole. The major questions of business strategy and regulatory policy in response to market failure can only be decided by entire boards. Similarly, the approval of company standards and values is something boards cannot sensibly delegate.

On the other hand, many board tasks fit naturally within the remits of existing standard board committees. It is the responsibility of the remuneration committees, for example, to ensure – to the extent possible – that executive pay is aligned and not in conflict with corporate responsibility. The Remuneration Committees may also review the remuneration policies for executives at the level below the board to consider whether they are creating undesirable incentives. Similarly, 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.

Is a special committee needed?

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 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. If 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, special Corporate Responsibility Committees will have quite a limited job to do. It would therefore 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.

Conclusion

Following the publication of the report, Insight plans to engage with the boards of a number of FTSE 100 companies to discuss its findings and recommendations. We have already met with the company secretary of Cadbury Schweppes and will hold meetings in the early new year with Tesco and Rio Tinto. During 2006, we plan to incorporate discussion of the recommendations from the report in our work on regulation, internal control and ethics codes, as well as in our more routine meetings with companies..

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