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ACCOUNTANTS FOR BUSINESS

Risk and Reward: Shared perspectives

FIVE MINUTES ON...

Risk and Reward: Shared perspectives



In 2010 ACCA published *Risk and Reward: Tempering the Pursuit of Profit*. The paper explored the nature of the dynamics that drive corporate planning and accountability, focusing on the broad range of risks which need to be identified and managed.

One of the areas of risk that warrants particular attention is behavioural risk. The paper argued that while guidance, standards and supervision undoubtedly have a role to play in regulating corporate activities, those activities are ultimately the result of the behaviour of companies' lead actors. Whether regulatory standards of various kinds are framed as rules-based or principles-based, what will always be of fundamental importance is the preparedness of companies to apply them honestly, ethically and transparently.

Accordingly, if business is to be conducted in a way which is going to be consistent with the

interests of investors and wider society, more attention needs to be paid to how this issue of behavioural risk can be interwoven with regulatory mechanisms so as to ensure, as far as is practicable, that directors and executives act in accordance with the spirit as well as the letter of the law and standards.

ACCA is pursuing this agenda in its own activities and on behalf of its members by promoting the concept of 'public value'. This entails acting not only in the public interest but also in a way which delivers added value to stakeholders through, for example, good corporate governance, enabling access to finance or protecting clients' wider interests.

John Davies
Head of technical

View from the public sector

ETHICAL LEADERSHIP AND ETHICS DRIVING PERFORMANCE ARE HOT TOPICS IN THE PUBLIC SECTOR NOT LEAST BECAUSE OF RECENT SCANDALS ACROSS BOTH THE PUBLIC AND PRIVATE SECTORS. RISK AND REWARD: SHARED PERSPECTIVES EXPLORES A NUMBER OF TOPICS FROM ETHICAL LEADERSHIP TO CONSIDERING THE IMPACT OF AN ETHICAL CULTURE ON PERFORMANCE AND WHETHER IT CAN BE MEASURED. IT ALSO HIGHLIGHTS SOME RECENT DEVELOPMENTS, SUCH AS FRAMEWORKS FOR ASSESSING THE ETHICAL HEALTH OF AN ORGANISATION.

In the public sector context, strong ethical leadership plays an important role in delivering effective public services. Paolo Giusta of the European Commission argues that ethical leaders are characterised as not only having personal integrity and trustworthiness, but also an awareness of the bigger picture and the context in which their actions are taking place. A leader exhibiting these characteristics will have the ability to inspire those around them to act in way that makes change and service improvement possible. Similarly, Professor Michael Macaulay of Teesside University believes that ethical leaders are outward-facing individuals who are honest about problems and champion successes. Both conclude that the link between ethical leadership and ethical performance is crucial for improving organisational performance.

ACCA's Gillian Fawcett writes that common sense should tell us that a strong ethical culture will be reflected in high-performing public services, but the evidence to support this is scarce and the literature available

suggests there are too many other factors to take into account to establish a causal link. Also there are factors which are simply not measurable, such as the ethical culture of an organisation or the time lags between when a board reacts and makes decisions and when performance responds. Fawcett calls for further research in this area.

There are many definitions of ethical governance in the public sector and it is all too easy to get drawn into the pros and cons of each definition. However, Alison Kelly of the Audit Commission in the UK neatly situates ethics within a wider modern definition of governance: 'ensuring the organisation is doing the right things, in the right way, for the right people, in a timely, inclusive, open, honest and accountable manner'. Currently, this definition is being widely adopted by public bodies because it is simple and easily understood.

Equally, there is a plethora of codes, guidance and frameworks for politicians, officers and auditors to follow, and assessment tools

to measure the ethical performance of an organisation. The latter is now more popularly known as ethical audit. Macaulay sets out three levels of an ethical audit: compliance, organisational processes and outcomes. The first two levels are relatively easy to assess and measure, such as how well an organisation complies with codes of conduct and protocols, and the effectiveness of the organisation's decision-making processes. But assessing for outcomes can be so much trickier. This is largely because the standard of measurement for outcomes is often outside an organisation's hands and resides with the public, media and politicians' perceptions.

The importance of ethical leadership and governance cannot be underestimated for improving public services. The ability of a strong ethical leader to inspire others to change and adapt along with the promotion of a positive ethical culture are prerequisites for innovating public services in times of financial constraint.

View from the private sector

RUNNING A BUSINESS IS NEVER STRAIGHTFORWARD BUT THESE DAYS IT IS HARDER THAN EVER AS THE ECONOMY STRUGGLES TO RECOVER FROM THE AFTERMATH OF THE CREDIT CRUNCH AND GOVERNMENTS STRUGGLE TO REDUCE DEBT. THE FUTURE SEEMS MORE UNCLEAR THAN EVER. WE WILL HAVE TO CONTEND WITH MORE FREQUENT AND MORE EXTREME CYCLES OF BOOM AND BUST. WHILE WE HAVE BEEN EXPERIENCING EXTREME FINANCIAL EVENTS THERE HAVE ALSO BEEN MORE EXTREME CLIMATE EVENTS. ON A HUMAN SIDE, WHILE THE RICH STAY RICH, MANY REMAIN IN POVERTY; DEMOGRAPHIC CHANGES MEAN SOME ECONOMIES WILL HAVE TOO FEW PEOPLE OF WORKING AGE TO PAY FOR A WELFARE STATE FOR AN AGING SOCIETY. THIS IS NOT JUST A PROBLEM FOR DEVELOPED COUNTRIES; DEVELOPING ONES WILL ALSO HAVE DEMOGRAPHIC CHALLENGES IF THEY LIMIT POPULATION GROWTH. WE SHOULD REMEMBER TOO THAT THE EARTH'S RESOURCES ARE FINITE AND SOONER OR LATER WORLD ECONOMIES WILL BE AFFECTED – BY SHORTAGES OF ENERGY, WATER, RAW MATERIALS OR NEW CHALLENGES FEW HAVE FORESEEN.

Investors wanting to invest for the long term are finding things truly hard. People saving for pensions are finally realising that their money, far from growing nicely to finance their retirement, may not even keep up with inflation. Institutional investors are feeling the strain at a time when they are being expected by governments finally to play an effective role in the governance of the companies they invest in. In particular they are now expected to hold companies to account and make sure they do not embark on disastrously risky strategies. Meanwhile, many of those close to or already retired are finding that with interest rates so low their savings seem almost worthless.

It is against this complex pattern of financial, economic and human challenge that businesses must be successful, not just to reward their owners and those who work in them but to build value for society. The consequences would be serious if they cannot: there would be lower employment and indebted countries would not be able to afford their national debt, pay for a public sector or for welfare.

In our collection of essays, Louise Rouse of FairPensions discusses how businesses could be made more accountable to investors. ACCA's Paul Moxey suggests that new ways of measuring added value are needed and that companies should report how they believe they contribute to the public good.

How can investors tell if some dreadful risk is about to engulf a company and reduce the value of their investment accordingly? Seb Beloe of Henderson Global Investors and Mark Anderson of PwC offer an innovative solution. Dr Andrea Coulson of the University of Strathclyde considers how banks and the financial sector can better consider the systemic risks posed by climate change and environmental risks.

As business and society realise they are mutually dependent, sound ethics will become particularly important.

Essays in focus

Louise Rouse, director of investor engagement at FairPensions, discusses the public policy value of making businesses more accountable to their investors, very much in the light of the aftermath of the global financial crisis and the BP oil spill in the Gulf of Mexico, and the huge financial and reputational costs associated with those events.

For this to happen, there needs to be full commitment from companies to identifying and managing all material risks facing them, both in the short term and the long term. These risks must be seen to include risks of an environmental and reputational nature. This needs to be followed up by effective disclosure regulations and enforcement of those regulations by the authorities.

There also needs to be a renewed focus on the importance of shareholders, as the ultimate owners of companies, paying sufficient attention to how companies are being run to enable them to satisfy themselves that the issue of risk is being effectively addressed.

For too many companies, consideration of environmental, social and governance (ESG) issues is limited to activities which are focused on operational cost reduction and reputation enhancement, rather than the identification and management of material business risks. Recent events have highlighted the necessity for a change in these practices. This change will require action from all participants in the investment chain. Regulators must enable this action through initiatives such as the introduction of requirements for a robust management commentary report that ensures the provision of forward-looking strategic disclosures on all material risks, including environmental and social risks.

Institutional investors must scrutinise and use such disclosures to engage effectively with companies on ESG issues and demonstrate transparently to their asset-owner clients and ultimate beneficiaries that they are dealing with ESG risks.

Fundamentally, she argues that environmental and social issues must be placed at the heart of investor stewardship by both investors and regulators. And the general public, whose savings are invested in companies, must become more engaged with their money managers and express their preferences for action on environmental and social issues. Greater accountability to the ultimate beneficiaries would be facilitated by the introduction of strong requirements for pension providers to report to pension savers on the integration of ESG decisions into investment decisions.

Finally, she argues that environmental and

social issues must be placed at the heart of investor and corporate decision making so that companies, investors and individual savers will be in a better position to prevent or at least mitigate any future financially devastating events such as the banking crisis and the Gulf of Mexico oil spill.

If investors are to be encouraged to play a more active engagement role, then they need to be capable of understanding not only the information provided by companies to the market place but the nature and scale of the risks that a company faces in the external environment. Ethics risk is increasingly seen as a major risk, especially in the listed company sphere, and it is a material issue for investor groups.

Seb Beloe of Henderson Global Investors and Mark Anderson of PwC present a tool for helping investors identify and manage business ethics risks.

Their starting point is that developments in regulation have had the effect of increasing risk in the area of business ethics. They quote from a 2010 survey conducted by PwC which found that 70% of respondents agreed or strongly agreed that they identified ethical risks but only 34% reported that those risks were currently adequately measured or evaluated; 27% of respondents confirmed that they had recently terminated a business relationship as a response to unethical behaviour.

In the tool, Beloe and Anderson set out a collection of 'red flag' factors, which relate to specific business characteristics that have traditionally been linked to a high incidence of business ethics issues. They identify over 50 separate red flags, grouped into five broad categories:

- type of industry
- country of operation
- company structure and business model
- management integrity and supervision
- high-level financial indicators.

The authors describe how, as part of a piloting exercise, they then engaged with company managements to explore the quality and depth of the control systems that each had put in place to manage their red flag issues, a process which enabled them to make a number of key findings. Beloe and Anderson suggest that their tool is capable of application at portfolio level and on a stock-by-stock analysis basis.

Professor Michael Macauley of the University of Teesside in the UK approaches the issue of business ethics from a different perspective – namely how can a business go about measuring its own ethical performance? While his analysis focuses specifically on measurement in the public sector context, it is likely to be equally relevant to the private sector.

He puts forward a case for structuring the measurement process (or the 'ethical audit') into four separate stages – planning, fieldwork, reporting and follow up. At the first stage, the scope of the audit must be clarified: this should take into account relevant compliance mechanisms. At the second stage, two separate tools are discussed as being potentially appropriate – the ethical governance toolkit and the ethical climate framework. The report stage must effectively identify key ethical risks facing the business and should provide recommendations for minimising those risks. The final, follow-up stage should identify how any recommendations should be implemented and provide a framework for monitoring progress.

While acknowledging the difficulty of accurately measuring ethical performance, Macauley sees the link between ethical leadership and ethical performance as crucial. He supports the assertion that the appearance of strong leadership without the requisite degree of intent or authenticity is one of the main signs of ethical collapse in organisations. He concludes by arguing that an effective business leader is one who is honest about problems that have arisen and champions the successes which have been achieved.

About shared perspectives

Risk and Reward: Shared perspectives is a collection of 11 individual essays discussing different aspects of the overriding theme of corporate responsibility and ethics.

We look at how investor groups see the significance of risk and pose the question of whether it is feasible to expect commercial businesses to operate in accordance with some conception of the 'public good'. We also acknowledge that the issue of behavioural risk impacts on the public sector just as it does the private sector. A number of contributions address the application and measurement of ethical principles and consider how those principles might impact on performance.

Read the full report: www.accaglobal.com/accountants_business

The essays

Making businesses more accountable to investors

Louise Rouse, director of investor engagement, FairPensions

Ethical leadership: lessons from two biographies

Paolo Giusta, director general, research and technological development, strategic planning office, European Commission

Avoiding bear-traps: an investor tool for identifying and managing business ethics risk

Seb Beloe, head of SRI research, Henderson Global Investors, and Mark Anderson, director, forensic services, PwC

Measuring ethical performance

Professor Michael Macaulay, reader in governance, Teesside Business School

Capitalism and the concept of public good

Paul Moxey, head of corporate governance and risk management, ACCA

Company law and the concept of corporate social responsibility

John Davies, head of technical, ACCA

Learning from environmental credit risk management

Dr Andrea Coulson, senior lecturer in accounting, University of Strathclyde, and chair of ACCA's sustainability committee

Ensuring good ethical governance in partnership arrangements

Dr Gary Hickey and Piers Bainton, Standards for England

Ethics: does ethical governance actually lead to better organisational performance?

Gillian Fawcett, head of public sector, ACCA

Ethical governance and the Audit Commission

Alison Kelly, national lead, governance and accountability, Audit Commission

ACCA (the Association of Chartered Certified Accountants) is the global body for professional accountants. We aim to offer business-relevant, first-choice qualifications to people of application, ability and ambition around the world who seek a rewarding career in accountancy, finance and management.

Founded in 1904, ACCA has consistently held unique core values: opportunity, diversity, innovation, integrity and accountability. We believe that accountants bring value to economies at all stages of their development. We seek to develop capacity in the profession and encourage the adoption of global standards. Our values are aligned to the needs of employers in all sectors and we ensure that, through our qualifications, we prepare accountants for business. We seek to open up the profession to people of all backgrounds and remove artificial barriers, innovating our qualifications and their delivery to meet the diverse needs of trainee professionals and their employers.

We support our 147,000 members and 424,000 students in 170 countries, helping them to develop successful careers in accounting and business, based on the skills required by employers. We work through a network of 83 offices and centres and more than 8,000 Approved Employers worldwide, who provide high standards of employee learning and development. Through our public interest remit, we promote appropriate regulation of accounting and conduct relevant research to ensure accountancy continues to grow in reputation and influence.

Accountants for Business

ACCA's Accountants for Business programme of research and insights champions the role of finance professionals in all sectors as true value creators in organisations. Through people, process and professionalism, accountants are central to great performance. They shape business strategy through a deep understanding of financial drivers and seek opportunities for long-term success. By focusing on the critical role professional accountants play in economies at all stages of development around the world, and in diverse organisations, ACCA seeks to highlight and enhance the role the accountancy profession plays in supporting a healthy global economy.