



Corporate Governance: The stakeholder challenge

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Status report

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Britain has entered the twenty-first century with what is widely regarded as one of the best systems of corporate governance in the world. After a decade of immense effort and four major investigations, quoted companies operate under a regime which specifies more tightly than ever before, and more determinedly than in any other country, how directors should operate in the boardroom.

Meanwhile international agencies and organisations have also developed tougher rules for the way companies are governed. The Commonwealth launched its own principles for corporate governance in November 1999

and the Organisation for Economic Co-operation and Development (OECD) has updated its guidelines on how multinationals should behave. Yet despite these considerable advances there is still dissatisfaction with the nature of boards' responsibilities and UK company law faces its most fundamental shake-up for more than a century.

THE STATE OF PLAY IN BRITAIN

Since January 1999, UK quoted companies have been required by Stock Exchange listing rules to comply with the Combined Code.¹ This Code was the product of the Hampel Committee's² deliberations – the third major investigation into boardroom

practice in the 1990s. The latter committee was established in November 1995 to review the impact of the two previous investigations, under Sir Adrian Cadbury³ and Sir Richard Greenbury,⁴ and to tie up any loose ends (except for the question of internal controls – see below).

The Hampel Committee represented the culmination of a huge effort which had been prompted initially by the financial scandals of the late 1980s, most prominently the collapse of Maxwell Communications and Polly Peck. The perception that such corporate disasters demonstrated lax auditing practices led the Institute of

Chartered Accountants in England and Wales to set up the Cadbury Committee. Its remit was to investigate only the financial aspects of corporate governance, but Sir Adrian Cadbury and his colleagues went much further than the finance function and audit arrangements.

The main thrust of the Cadbury Code was aimed at preventing the kind of personal boardroom dominance exercised by Robert Maxwell at MCC and Asil Nadir at Polly Peck. Companies were urged to separate the roles of chairman and chief executive as a means of diluting the power at the top of the company. They were required to include independent non-executive

directors to bolster this countervailing force in the boardroom. It was recommended that non-executives should form an audit committee to bolster auditor independence from the executive directors, and take charge of the remuneration committee to introduce independence when deciding on directors' remuneration packages.

Among other matters in the Code, directors were called on to report on internal controls – a matter which was not finally resolved until the end of the decade with the publication of the Turnbull Report.

Cadbury's attempt to deal with the growing controversy over boardroom pay was not enough to cope with the public anger and political embarrassment caused by dramatic rises in executive remuneration packages during the early 1990s. The difficult situations facing boards of privatised utilities such as British Gas became public knowledge. Attempts to introduce conventional private sector pay packages into these privatised boardrooms caused furores such as the shareholder revolt in 1995 over the pay of British Gas chief executive Cedric Brown. However, the board, backed by institutional shareholders, won the day. But the episode underlined the need for a

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re-examination of remuneration practices as well as the role of institutions in corporate governance.

A committee under Sir Richard Greenbury reported in 1995 with another Code aimed at improving information about directors' pay, and therefore aiding accountability. It resulted in the lengthy remuneration reports now seen in company annual reports, showing full details of each director's package.

The Greenbury Committee warned against total rewards being "excessive". It especially wanted to stamp out "payment for failure" – the award to departing

executives of large compensation for cancellation of lengthy contracts – and wanted to tilt the balance of boardroom pay towards performance-related sums. This was to be achieved by setting normal contract periods of no more than 12 months, and by introducing incentive schemes based on "challenging performance criteria" over longer periods than had been normal. The 1980s' practice of awarding one-off share options, especially at a discount, was particularly frowned upon.

The Greenbury Code also suggested that directors' annual pay increases should take account of pay rises elsewhere in the

company, but stopped short of saying they should be directly linked. And it concluded that remuneration committees' reports to shareholders should not normally be voted on separately at the annual meeting.

Both Cadbury and Greenbury called for the impact of their work to be reviewed, and this task fell to Sir Ronnie Hampel. His report was published at the beginning of 1998 and resulted in the Combined Code which now defines listed company governance.

The Combined Code, as its name implies, brought together the existing requirements, and in some

cases strengthened them, e.g. the presence and roles of non-executives. It introduced a set of Principles of Good Governance and a Code of Best Practice for following the Principles. The Principles introduced an important new element aimed at taking corporate governance beyond the boardroom and out into the shareholder community.

In a section on improving annual meetings, the Principles require proxy votes to be counted and announced, separate votes to be taken on key issues, chairmen of key board committees to be available to answer questions, and AGM papers to be sent to shareholders four weeks ahead of

the meeting. In short, Hampel wanted to revive shareholder democracy, which had become dormant as shareholdings became concentrated in fewer and fewer institutional hands.

This externally focused element of the Combined Code also went beyond the previous limits of corporate governance to provide principles for institutional shareholders. This picked up on growing concerns about the failure of pension funds, insurance companies and other institutions to make shareholder democracy work. Institutions were urged to exercise their votes at shareholder meetings, to ensure good communications with invested

companies, and to monitor companies' corporate governance arrangements.

PROGRESS

Most major companies implemented the key recommendations in the Cadbury and Greenbury reports, so the main elements of the Combined Code were quickly adopted by many companies. Despite a decade of pressure, however, many gaps remained at the start of the new century, especially outside the top echelon of companies. Few companies can claim to be fully compliant.

Research in 2000 by the corporate governance specialists Pensions

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Industry Research Consultants (PIRC) found that only 17% of the FTSE All-Share Index claimed to comply fully with the new Code. The greatest advance was on the length of directors' contracts. Almost 70% of directors in these 500 companies had a contract of no more than one year. However, at the other end of the compliance scale, almost half of these companies still do not have a majority of non-executives on their boards.

There was also still a long way to go on separating the posts of chairman and chief executive and in increasing the number of independent non-executives. Over 100 of these companies still have

not created fully independent remuneration and audit committees. The challenge is to carry progress beyond the top group of FTSE companies, which tend to face greater scrutiny and have therefore been quicker to respond. Many smaller quoted companies still feel comfortable with intimate boards which fail to incorporate the checks and balances demanded by Cadbury and its successors.

INTERNAL CONTROL

A final element of the Hampel deliberations harked back to the corporate collapses which had prompted the preoccupation with corporate governance at the start of the 1990s. Hampel repeated Cadbury's request that directors

should comment on their companies' internal controls, and made clear this should not merely refer to financial controls.

Another committee, under Nigel Turnbull, was duly appointed to advise how this requirement should be implemented. It put in place the final piece of the UK corporate governance jigsaw, effective for accounts ending in December 2000. Turnbull drove home the message that risk is inherent in business and risk management is a key management responsibility. He stressed that monitoring internal controls should be part of normal management practice, not something carried out purely to comply with the corporate

governance guidelines. But the central message of the Turnbull Report was that risk is both endemic and pervasive. It covers risks from environmental disasters and infringements of human rights as well as financial irregularities. It is ever-present and ever-changing, and internal controls should recognise this diversity and fluidity.

INTERNATIONAL DEVELOPMENTS

Publication of the Turnbull Report⁵ completed the 1990s' modernisation of British corporate governance. But international developments highlighted the relatively limited scope even of these four major reports – a broad agenda still had to be addressed.

With interest in governance spreading around the world, the Commonwealth published *Principles for Corporate Governance in the Commonwealth*.⁶ It stressed the broad nature of good governance: "Society expects a corporation to act responsibly in regard to aspects concerning its broader constituency such as the environment, health and safety, employee relations, equal opportunity, the effect of anti-competitive practices, ethical consumer conduct etc."

Even more significant, the OECD club of industrial countries launched an updated version of its *Multinational Enterprise Guidelines*⁷ at the end of June

2000. The Guidelines update the voluntary OECD code which was first introduced in 1976, prompted by concerns about bribery and the power of multinationals in developing countries.

The OECD Code sets out the standards of behaviour OECD governments expect companies to observe wherever they operate around the world. The latter is a significant strengthening – the previous version applied only to operations within OECD countries.

The Guidelines cover a wide range of corporate issues. The main focus is on shareholders and boardroom practice – this accounts for three of the five sections. But a section is

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also devoted to other stakeholder rights, on the basis that “the interests of the corporation are served by recognising the interests of stakeholders and their contribution to the long-term success of the corporation”. Boards are also urged to take account of environmental and social issues.

The OECD makes clear its belief that good corporate governance is a necessary accompaniment to globalisation, and that it is in companies’ interests:

“If countries are to reap the full benefits of the global capital market, and if they are to attract long-term ‘patient’ capital, corporate governance

arrangements must be credible and well understood across borders. Even if corporations do not rely primarily on foreign sources of capital, adherence to good corporate governance practices will help improve the confidence of domestic investors, may reduce the cost of capital, and ultimately induce more stable sources of financing.”

The wide-ranging scope of the OECD Code highlighted the fact that all the effort at improving British corporate governance during the 1990s had been extremely limited. It had been focused almost exclusively on the boardroom, especially the

technical aspects of board constitution and conduct.

Other developments, however, such as the review of company law, are addressing these wider issues. The remainder of this booklet examines the wider context and the implications for directors of likely developments.

NOTES

¹ Strictly speaking, listing rule 12.43A requires only that companies say how they have applied the Hampel Principles, the extent to which they have complied with the Code and the reasons for any non-compliance. The Code is appended to the listing rules but not actually part of them.

² Hampel. *Report of the committee on corporate governance*, Gee Publishing, 1998.

³ Cadbury. *Committee on the financial aspects of corporate governance*, Gee Publishing, 1992.

⁴ Greenbury. *Directors' remuneration: report of a study group*, Gee Publishing, 1995

⁵ Turnball. *Internal control: guidance for directors*, Institute of Chartered Certified Accountants in England and Wales, 1999.

⁶ CACG *Guidelines – Principles for corporate governance in the*

Commonwealth, Commonwealth Association for Corporate Governance, 1999.

⁷ *Principles for Corporate Governance in the Commonwealth*, OECD, 2000.

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Active shareholders

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The various domestic and international codes have set out how boards should behave. But a key element in the development of corporate governance is policing, and shareholders have largely been left with this role. The Combined Code is an adjunct to the Stock Exchange listing requirements, not part of it. And companies are required only to report whether or not they comply with its requirements – they are not required to comply with it. It has therefore been up to shareholders to protest and apply pressure on companies that have failed to follow the guidelines for boardroom composition, pay, etc.

This fits in with a wider, worldwide trend for institutional shareholders to take a more active approach to their investments. Beginning in the USA, but now spreading through Europe and elsewhere, an “active shareholder movement” has grown. Initially, it was dedicated to the belief that as owners, the shareholders should not tolerate sustained poor financial performance. Instead of selling shares in poorly performing companies, as in the past, some institutions have opted to apply pressure on managements to change their strategies, and in some cases to change their management teams completely.

At the same time many campaigners on issues ranging from environmental

protection to human rights have bought shares in their target companies. Initially this was merely to gain entry to the annual meeting, which provided a perfect platform for their protests. But they have now moved on from this broadly negative approach, bringing shareholder resolutions which in some cases have attracted substantial support from mainstream investors.

The non-traditional issues raised by campaign groups have also been pursued by ethical investment funds. But these are also now being addressed by some mainstream investment institutions, mainly as a result of a new pensions regulation which came into effect in July 2000. The

amendment to the 1995 Pensions Act requires trustees to include in their annual statement of investment principles (SIP) comments on:

“the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments;

their policy (if any) directing the exercise of rights (including voting rights) attaching to investments.”

While this regulation carefully avoided interfering in the investment approach of trustees,

the requirement to address ethical issues prompted funds to develop policies for this area – an area which most had previously ignored. Equally important, though largely overlooked, the second part of the new requirement added further impetus to the call from the Hampel Committee for institutions to be more active in voting with their shares.

As a result, companies now face two different forms of shareholder activism. First, from mainstream shareholders on (a) basic financial performance and strategy; (b) on conventional corporate governance issues enshrined in the Combined Code; and (c) on social and environmental issues. Second,

companies also face shareholder activism from campaigners, on issues such as labour standards, human rights and environmental protection.

THE VOTING CHALLENGE

The Cadbury Committee observed that voting rights represent an asset which should be used. The Labour government picked up this theme, arguing that shareholder votes should be a key element of effective corporate governance. Ministers pointed out that voting was an essential part of shareholder democracy, and hinted at the prospect of making voting compulsory if levels of participation did not improve.

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Following such pressures, the National Association of Pension Funds (NAPF) launched an inquiry in 1998. The nine-month investigation, led by former Hanson company secretary Yve Newbold, concluded that there were practical problems which do hamper shareholders' efforts to exercise their ownership rights at annual meetings. But it concluded that cultural change was also needed, so that institutions would regard voting as a routine element of their fiduciary responsibilities.

The inquiry found that only 40–45% of shares were typically voted at annual meetings, and set a target of 60% to avoid the threat of government action, possibly

leading to compulsory voting. It blamed the low turnout on a series of factors, beginning with a marked reluctance on the part of some institutions to engage with the voting process.

In some cases, however, shareholders' attempts to cast their votes were frustrated by an outmoded paper-maze linking the actual shareholders, through fund managers and custodians, to the registrars responsible for maintaining share registers. Electronic systems were recommended to overcome this hurdle (see section 5 on E-governance). But to push voting levels up to a majority of shareholders even without

electronic methods, the committee also called for the following:

- **Trustees** to ensure they have appropriate voting policies and that they are implemented by investment managers who have powers delegated to them.
- **Fund managers** to push clients to adopt voting policies and make sure their own back-office systems are capable of implementing them.
- **Companies** to take voting more seriously and encourage shareholders to do likewise.

MOUNTING PRESSURE

The voting challenge has been picked up by the two main institutional groups, the NAPF and the Association of British Insurers

(ABI). Both had operated a voting issues service for members for several years, restricted to highlighting what were described as “contentious issues”, but without offering any advice on which way to vote. At the start of 2000 the scope of the NAPF service was expanded to include social and environmental matters, and it became a fully-fledged voting service with clear policy on all corporate governance matters.

The principal policy position was to support boards unless there were strong reasons not to, but the Association recommended opposing:

- combined chair/chief executive
- contracts beyond one year for

new directors and two years for reappointments

- pay and bonus schemes not meeting “good practice” norms.

The ABI has become more involved in a different way. In November 2000 it focused on one of the early corporate governance issues which had never been properly addressed – the question of joint chairs/chief executives. The Cadbury Committee had called for separation of these top roles, mindful of the power wielded by Robert Maxwell at MCC and Asil Nadir at Polly Peck. It stopped short of prohibiting the joint position, but argued strongly that it was a dangerous practice.

In November 2000 the ABI wrote to more than 20 out of the 350 public companies that had not heeded the warnings of Cadbury and its successors. Unusually, the Association made public its concerns, demonstrating a new willingness to go beyond the usual discreet conversations when such private pressure appears to be having little impact.

GINGER GROUPS

The positions of members of these two investor organisations vary widely, however. The local authority funds, organised in the Local Authority Pension Fund Forum (LAPFF) have tended to be the most active. Many of these funds are advised by the research

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ginger group Pensions Industry Research Consultants (PIRC). PIRC has published detailed voting guidance since the early 1990s, taking a hard line on a wide range of corporate governance issues.

The LAPFF has mounted a series of campaigns to persuade companies to improve performance on a variety of issues. The first was aimed at the performance targets in directors' bonus schemes. It wanted companies to set minimum performance levels above the median and with earnings per share growth of more than 2% – standard conditions in many share schemes. After lobbying more than 50 companies the LAPFF claimed

that a quarter had toughened their performance criteria. Subsequent campaigns focused on retailers which did not have adequate codes for labour standards, especially concerning suppliers from developing countries, and companies that did not produce environmental reports.

These latter developments emphasise that shareholder pressure is rarely about voting at annual meetings. More usually it is a matter of pressure in private meetings, sometimes by individual institutions, sometimes by several working together, and occasionally by their associations.

An informal group of mainstream institutions most concerned with governance, known as the Corporate Governance Forum, developed its own informal “code” and a co-operative approach to these issues. Beginning with the kind of issues highlighted by the Cadbury Committee, the Forum went on to develop a view on key social and environmental issues which shareholders should be concerned about and informed about by companies.

Again, most of the Forum's work took place in private. But occasionally, when boards fail to respond, these private conversations burst on to the public stage. Several examples in

2000 demonstrate the range of issues that raise shareholders' concerns, plus the impact which public condemnation can have, but also demonstrate the limits of shareholders' nominal voting power:

- **Pay at Vodafone** – following the successful acquisitions of Airtouch and Mannesmann, the Vodafone board handed chief executive Chris Gent a £5m cash bonus and the opportunity to earn a further £5m in shares over two years. The bonuses breached best practice rules, while the scale of the payments sparked controversy. The company complained that it had consulted major shareholders, but they said the

payments had been presented as a *fait accompli*. At the annual meeting 30% of votes were cast against the board remuneration package, even though shareholder unrest had forced some concessions from the company.

- **Strategy at Compass** – shareholders objected to the terms of the deal for catering group Compass to merge with Granada's hospitality arm. Despite their misgivings, shareholders voted the deal through, arguing that they had no alternative because of the potential impact on the Compass share price if the deal fell through.

- **Management at Tomkins** – the conglomerate's chief executive, Greg Hutchings, was forced out after details emerged of perks he had enjoyed. Shareholders had been unhappy with its strategy for years and finally took the opportunity to express their disapproval by removing the architect of the group.

OUTSIDE THE CITY

Campaigners have become adept at using conventional mechanisms such as the annual meeting as well as traditional lobbying tactics applied to financial targets. The extent of and support for such tactics have been growing.

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Two shareholder resolutions in 2000 are worthy of note because of the support they achieved:

- **BP Amoco** – a coalition led by Greenpeace and the US social investor Trillium Asset Management won the backing of 1.4bn shares (13.5%) for a resolution based on environmental concerns. The resolution called on the oil group to abandon its Northstar Arctic exploration project and to divert the investment into renewable energy projects.
- **Rio Tinto** – ground-breaking co-operation between trade unions in the UK, Australia and the USA produced two resolutions. The first was concerned with a standard aspect of corporate

governance – the independence of a proposed deputy chairman. Despite stiff opposition from the company the resolution won the backing of almost a third of those voting (excluding abstentions). The second resolution was concerned with labour standards. It called on Rio Tinto to adopt a code of conduct concerning employees in line with International Labour Organisation conventions. Despite the narrower focus, this resolution won the support of 28% of those voting.

The scale of support for these resolutions demonstrates how such issues have become more or less

mainstream and cannot be dismissed by companies in the way they probably would have been in the early 1990s.

Equally significant, though with much narrower support, was the action of animal rights activists against investors in and backers of Huntingdon Life Sciences. This company attracted controversy because its operations included medical tests on animals. It had been criticised during the 1990s for allegedly poor practices but by the end of the decade was widely regarded as having exemplary policies and procedures. From the activists' point of view, however, it was unacceptable because of its use of animals in tests. Despite

concerns that the company could be driven abroad, where standards might be lower, the direct action campaign aimed to denude the company of financial advisers and backers. Using methods including threats of violence, it succeeded in persuading several institutions to sell their shares.

The Huntingdon case was the most extreme example of pressure on corporate behaviour using the financial network. It is unlikely to be repeated in many cases elsewhere, but it highlights the growing financial sophistication of activists, who in the past have been content merely to disrupt annual meetings.

There can be no doubt that every public company, and potentially private businesses as well, face potential challenges to their business practices, and that these challenges now range from traditional governance issues such as board structure to questions of how the business is carried on, and even whether the business should be carried on.

The next section examines the debate about how formally the wide responsibilities of business should be embraced by the law.

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The stakeholder debate

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The acknowledgement by the OECD of stakeholders such as suppliers, customers and communities was the first specific result of a debate which had heightened during the second half of the 1990s. The growing pressures from different groups referred to in section 2 demonstrate that companies' responsibilities have been increasingly seen in a wider context than the merely financial. This became a central issue in the government's fundamental review of company law.

The Company Law Review was launched by the new Labour government in March 1998. It aimed to go beyond the narrow

boardroom focus of the various 1990s' committees to produce a fundamental overhaul of what was still essentially seen as a Victorian approach to corporate law. This included modernisation of practical aspects such as company formation and shareholder voting. The critical issue was the item in the terms of reference calling for law which "protects the interests of those involved with the enterprise, including shareholders, creditors and employees". The first interim report from the review group¹ concluded from the submissions made to it: "there was agreement that the 'stakeholder' issue lay at the heart of the review, though no consensus on the most appropriate approach".

There are several strands to the debate. They include the long-running argument about the ascendancy of financial markets in the British economy,² which puts pressures on quoted companies to act primarily in the interest of short-term returns.

This financial dominance has typically been contrasted to the "Rhineish" model seen especially in Germany but also elsewhere on the continent. In Germany the system of two-tier boards subjects executives in theory to close scrutiny by a senior board which represents wider society as well as banks and shareholders.

Works councils are also a feature of the German system but also present in most European countries, and several large British businesses. These councils give worker representatives a forum in which to obtain information and raise issues of concern, separate from traditional trade union channels. Works councils have rights to be consulted in certain circumstances but they do not impinge on the formal corporate governance structure centred on the boardroom.

Proponents of a broader, stakeholder approach look beyond labour – the traditional “social partner” in European business. They argue that companies owe

responsibilities to society as a whole, and especially to particular groups such as suppliers, customers and communities. This argument has been pressed particularly by environmentalists, who believe companies should be embracing concepts of sustainable development.

ENLIGHTENED SELF-INTEREST

The financially-oriented side of the argument has been taken up strenuously by the Centre for Tomorrow’s Company. The Centre was established following the inquiry carried out by the Royal Society for the Arts, resulting in the *Tomorrow’s Company* report in 1995. The Centre exists to promote the concepts in that report, centred

around the notion of inclusiveness. Mark Goyder, the Centre’s director, explained what inclusion meant for business: “putting people and relationships at the heart of sustainable business success”.³ Essentially, the argument is that Tomorrow’s Companies would be most likely to achieve sustainable success by working in partnership with suppliers, customers, employees and communities.

Goyder argued that corporate governance, even as strengthened by the new requirements was fatally flawed because it rests on two misconceptions. The first of these is the focus on owners (shareholders) and managers (directors), which he argues does not embrace the crucial

The stakeholder debate (continued)

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issue of long-term “stewardship” – building assets for future generations. The second fatal flaw, so far as Goyder was concerned, is the inability of conventional reporting to embrace the broad sets of issues (many non-financial) which owners should use to judge the performance of managers.

This position does not attempt to challenge the supremacy of shareholders as owners of a company. It argues that the shareholders will ultimately be better off if they allow managers to pursue long-term objectives. And those objectives will include the enhanced status or reputation of the company in the eyes of its various stakeholders.

During the debate over the company law review, this became known as “enlightened shareholder value” – the pursuit of shareholder value but bearing in mind the rights and needs of players other than shareholders. Indeed, it had been described by Goyder as “enlightened self-interest”. This was the “inclusive” interpretation of Adam Smith’s market, where the pursuit of individual gain is balanced by mutual support. According to Goyder:

“Business, in this view, cannot opt out of its responsibilities as a citizen. It cannot sub-contract to some ‘invisible hand’ or to legislation and government, the responsibility

for ensuring that the consequences of its market-driven actions are acceptable.”

PLURALISM

Enlightened self-interest was not enough for those who argued that company directors face overwhelming pressure to prioritise short-term shareholder returns, and are therefore unable to balance the interests of various stakeholders. This view was propounded in the report of an inquiry⁴ backed by eight leading companies. The inquiry, carried out by organisations such as Business in the Community and Forum for the Future, urged the government to help companies deal with inevitable conflicts:

The stakeholder debate (continued)

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“Companies will continue to point out that there are clear limits to this convergence between competitiveness and stakeholder strategies. The engagement of government is crucial if the barriers to convergence are to be lifted, and corporate commitments to achieving the highest ethical, social and environmental standards are to be properly recognised and encouraged.”

The inquiry's recommendations included the following:

- the government should promote stakeholder business initiatives as a critical element in its overall competitiveness strategy

- the government should actively consider the possibility of setting up a directory of good practice on corporate governance and business ethics.

This enthusiasm for a stakeholder approach was not shared by most business and City organisations giving evidence to the Company Law Review. But the Review did receive submissions from “civil society groups” arguing that it was necessary to go further than “enlightened self-interest” if the law was to protect the interests of employees, communities and the environment from companies’ pursuit of profits.

The Review team dubbed this the “pluralist” approach because they saw it as aiming to make companies responsible to a broad group of stakeholders rather than to shareholders alone.

This “pluralist” position was rejected on the basis that it would be impracticable to frame the law in such a way. It was argued that the law would have to define rights, powers and duties in relation to the various stakeholders, and that this was not possible in the case of nebulous groups such as communities and issues such as the environment. The Review concluded that it would be dangerous to dilute the single-

The stakeholder debate (continued)

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channel accountability of company directors to their shareholders.

Most of those arguing for broader duties on company directors would have been happy to keep the formal single-channel responsibility to shareholders. They argued that within that responsibility, the law should explicitly state that directors should be required to take account of other stakeholders and the environment.

The consequences of this approach would be a need for company boards to demonstrate they had given due consideration to customers, employees, communities and environmental issues. Among other things, that would entail new

reporting requirements, adding social and environmental areas to the traditional financial reporting base.

REPORTING

Once the pluralist approach had been rejected by the Review group, the debate focused on the reporting question. Under the enlightened shareholder value model, directors were expected to monitor relationships with suppliers, customers and others, since this was seen as important in building long-term shareholder value. The question, then, was how companies should report on these relationships.

The Review group's second report⁵ recommended that the Operating

and Financial Review (OFR) which was already required under accounting standards rules, should become a legal requirement. It also suggested that this report, intended to encompass the company's performance and prospects, might include a broad range of social and environmental issues. But the report disappointed "pluralists" by calling for the inclusion of these broader matters only where directors considered them to be "material".

Compulsory elements in the new OFR are to be:

- a fair review of the development of the company's business, referring to products and markets, acquisitions and disposals

- the company's purpose, strategy and principal drivers of performance.

Other elements would be included only where "material", such as:

- an account of key relationships, including employment policies and practices, policies on payments to creditors
- corporate governance values and structures, including details of directors
- dynamics of the business, i.e. factors which may affect future performance, including competitive developments, financial and environmental risks, investments in intangible assets

- environmental policies and performance
- policies and performance on community, social, ethical and reputational issues
- receipts from and returns to shareholders.

This approach was confirmed in the third consultation⁶ but it is unclear whether it will be reflected in a Companies Act putting into law the Review team's recommendations in a second Labour government. The government had made clear throughout the process that it regarded the review as independent and would not be bound by its proposals. However, it seems likely that at least some of the optional items will end up as mandatory

elements of a new OFR, including environmental policies and performance.

In any event, the thrust of any eventual legislation is likely to put the onus on companies to cover these items. Even if they do not become mandatory, many companies are likely to face harsh questioning from pressure groups and some shareholders if they conclude that these issues are not "material". In effect, Britain appears to be on the verge of broad social and environmental reporting at some level, recognising – at least informally – that companies' relationships with all stakeholders are important.

The stakeholder debate (continued)

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Section 4 examines the risks to a company's reputation from this new, broader approach to corporate responsibility, and how to manage those risks.

NOTES

¹ *Modern Company Law for a Competitive Economy: The Strategic Framework*, Department of Trade and Industry, 1999.

² Expounded particularly by Will Hutton, *The State We're In*, Jonathan Cape, 1995.

³ Mark Goyder, *Living Tomorrow's Company*, Gower, 1998.

⁴ *A new vision for business*, Committee of Inquiry, London, 1999 (available through Business in the Community). This committee was backed by BP Amoco, British Telecom, Diageo, NatWest, Body Shop, Tesco, Unipart and Wessex Water.

⁵ *Modern Company Law for a Competitive Economy: Developing the Framework*, Department of Trade and Industry, 2000.

⁶ *Modern Company Law for a Competitive Economy – Completing the Structure*, Department of Trade and Industry, November, 2000.

Protecting a company's reputation

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The rise of stakeholder action of various kinds, regardless of how formally a company's responsibilities to different groups is recognised, has brought new and significant threats – quite apart from the specific threats from activists such as occurred in the Huntingdon Life Sciences case. The wider threat is to a company's reputation, and it hovers over every company in every industry, no matter how mundane their activities or how remote from the consumer they are.

Monsanto's experience with genetically modified soya bears this out. This was not a consumer company. Shoppers were not able

directly to boycott its products, since they were supplied to food manufacturers as ingredients in the products which finally appeared on the supermarket shelves. Yet the GM campaign was highly damaging for Monsanto's reputation – and for its business.

The Life Science Company's experience is different from most reputational issues, but not unique. Nike and Reebok, Shell and BP, have all suffered from faraway business practices being exposed to Western gaze. Other branded product companies have suffered one-off hits to their reputations – Perrier and Coca-Cola with contamination, Hoover with its damaging marketing promotion,

Microsoft and its clash with US anti-trust authorities.

Branded companies are clearly more vulnerable to reputational damage, because their product or corporate brand names are such a large part of their corporate value, and because that brand prominence means they are more likely to attract the attention of campaigners. So damage to the brand can have an immediate impact on retail sales.

The same can apply to business customers. Many companies have formal processes for assessing the ethical suitability of their suppliers. Others will be influenced by an informal view of a company's values and standards.

Protecting a company's reputation (continued)

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But reputation is important in more ways than just the potential loss of sales. Evidence has been piling up in recent years to show that a company's "ethical" reputation is important in attracting and retaining the best staff. For example, research for the Industrial Society in late 2000¹ demonstrated that the vast majority of professionals care about what their company stands for. More than four out of five of those asked said they would not work for an organisation whose values they did not believe in, and over half said they chose the company they work for because they believe in what it does and what it stands for.

Other partners are likely to be affected by reputation. For example, local, regional and central governments can have a variety of impacts on a company's operations. At the most formal end of the spectrum, these authorities grant licences and permissions (e.g. planning permission for a new building). A company's reputation will be important – and could be crucial – in influencing the politicians who make such decisions. Less formally, public authorities (and especially the politicians involved in them) can have an impact on the perception of a company by local communities. And politicians' perception of a company can have an important influence on their

reaction to key events, for example, the widespread negative reaction of MPs which sank the proposed takeover of ICI by Hanson in 1991 was largely due to the harsh reputation of the conglomerate compared to the more thoughtful approach of its prey.

The fact that such negative impacts might arise is a serious business risk which must be assessed by the board as part of its routine risk management, as required by the Turnbull Report. On the other hand, as Turnbull emphasised, risk is two-edged. While the risks of poor reputation can be considerable, equally, the opportunities stemming from enhanced reputation can also be valuable.

Protecting a company's reputation (continued)

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But where reputation used to be primarily a matter of building product brands through conventional marketing, it now rests to a large extent on social and environmental issues – Nike's trainers are only as good as consumers' image of the conditions under which they are made; BP depends partly on perceptions of its success in manufacturing solar panels. These are some of the risks which can arise from social and environmental issues which in the past might not have been considered by the board. Others are:

- pollution
- product flaws, including health and environmental risks
- unethical marketing

- poor treatment of the workforce
- low standards in suppliers' operations.

UNDERSTANDING REPUTATION RISK

Reputation risk from social or environmental activity is different from most risks managers have to deal with. There are two reasons for this. First, it is concerned with issues which many managers are not familiar or comfortable with – matters of ethics, morality and politics. And, second, it is partly a matter of perception – a company's appearance in the eyes of its stakeholders.

The importance of perception sometimes leads managers to

regard this as a public relations problem. That is a fundamental mistake. Public relations techniques can help to ensure that perceptions are not lagging behind reality, but they cannot sustain for long an image which is well ahead of reality. A company's real performance on social and environmental matters will soon emerge through any PR haze, just as financial performance cannot be obscured for long even by the most sophisticated investor relations spin.

But when addressing real performance, it can be difficult to understand what the issues are and how social and environmental performance will be measured.

Protecting a company's reputation (continued)

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There are no standards, barely a consensus on what the measures should be. Crucially, however, a company can no more decide what the key issues are than it can dictate the financial indicators which investors should use to assess financial performance.

Stakeholders – the interest groups which assess a company's reputation – will decide what matters. They will do this regardless of a company's actions and regardless of what managers think should be the key issues. It is essential, therefore, for managers to understand who the stakeholders are and what they are concerned about.

The usual process through which these matters are identified is known as "stakeholder dialogue". Such dialogue begins by asking what questions managers should ask about the performance of the business. It goes beyond the company's own internal preoccupations to discover those of the stakeholders.

This fundamental approach is essential if stakeholder dialogue is to be meaningful. Otherwise the exercise will be seen as putting on merely a display of openness rather than seriously allowing outsiders to make judgements. Companies which put on a façade of opening up to the views of stakeholders will become

discredited if it becomes seen as "greenwash" which actually has no impact.

Reputation feeds on itself. If well managed, it will be robust enough to withstand the occasional shock, such as an isolated example of non-compliance with labour conditions or a pollution incident. If poorly managed, reputation can spiral downwards, with half-hearted or cynical attempts at improving perceptions actually adding to a downward slide.

NOTES

¹*Corporate Nirvana: Is the Future Socially Responsible?* The Industrial Society, 2000.

E-governance

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5

The Internet revolution has several important implications for corporate governance. It affects the mechanics of voting, the potential for reporting, the risks to reputation, and possibly the importance of governance to trading partners. The rise of e-companies also has particular implications for boardroom behaviour and controls.

THE DOTCOM GENERATION

The new generation of Internet companies carries special governance risks. These companies are usually founded and run by young people with considerable technical and marketing expertise but little experience in mainstream

business. They are also in a hurry – the pace of development in this field means those who do not move at a breakneck pace will quickly be left behind. The result of these influences is that many areas of administration, including governance, are low down the list of priorities. Advisers to such companies need to be especially vigilant and persuasive to ensure that proper board structures, procedures and practices are followed, so that lack of attention to governance issues does not weaken these businesses and disadvantage stakeholders, ranging from suppliers to investors.

Inattention to governance is not the only concern in this fast-

moving sector. Possible fraud, unsuitable individuals and unacceptable practices are all potential concerns associated with a young industry operating in a “Wild West” kind of atmosphere – and these are not necessarily issues of youthful inexperience.

On the wider front, research for a government-backed inquiry found that three-quarters of the companies questioned had neither a policy to measure their own social and environmental impact – nor that of their suppliers. This included multinationals such as Amazon.com – not just the smaller companies which might be expected not to have addressed these issues formally. These findings emphasise

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that corporate governance in the widest sense should be at the top of the dotcom board's agenda.

E-COMMERCE

In another part of the Internet maze, governance issues could emerge as being important to companies vis-à-vis the success of web-based sales. It is not yet clear how the growth of e-commerce will affect buying decisions but it is possible to foresee two potential – and opposite – developments.

Web-based information should make it easier for buyers, whether personal or corporate, to compare prices. This is one of the great attractions of Internet commerce for all kinds of customers. One

consequence of this could be to increase the importance of price in the mix of factors influencing the buying decision. Quality, service and convenience may still remain significant criteria in such circumstances, but it is easy to see how broader and softer concerns could be downgraded – issues such as treatment of staff and environmental responsibility.

An opposite scenario can also be envisaged. The Internet makes it much easier to disseminate information about the social and environmental performance of companies to consumers around the globe. Research repeatedly shows shoppers to be concerned about such issues, but to be held back

from shopping ethically through lack of easy-access information.¹ It may be that ever-easier and cheaper Internet access could provide a means of leaping this information hurdle. In that case, the ease of price comparison would be matched by ease of ethical information gathering, and the non-financial performance of companies could move up the list of priorities when people are shopping.

A further factor could be important in the business-to-business market. Companies trading over the net are likely to find themselves doing business with new partners about which they know little. Buyers will want to reassure themselves about the probity and general standards

of the companies they are purchasing from. This may lead them to seek a broad range of information from all suppliers and incorporate this routinely in their buying decisions. Internet-based services are also springing up which will provide a database of “approved” ethical companies,² making it even easier to find suppliers that meet key performance criteria.

Both of these opposing trends are likely to be seen as e-commerce develops – some consumers will focus on price, others will take advantage of more accessible ethical information. Only time will tell which will dominate.

INTERNET ACTIVISM

The Internet is often touted as the key tool of radical activists and the reason why so many of them gathered in locations such as Seattle and Prague to protest so successfully (at least in terms of publicity attracted) against some or all aspects of global capitalism. It is easy to overstate this impact. After all, campaigners have succeeded in organising demonstrations and even revolutions down the centuries, without even the benefit of telephones. Nevertheless, net-based information is much more accessible than paper records and communications, and the culture of the Internet has also stimulated different forms of activism.

The anti-globalisation protests represent one kind of such activism, which can have serious implications for individual companies as well as for governments and the intergovernmental organisations which are the main target of the protests. Several elements of these protests need to be recognised:

- **Information** – the net makes it easier to gather information on corporate activities. This is not necessarily because more information is available, but because the available information, from companies themselves, from pressure groups and government agencies, is easier to find.

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- **Communication** – in the past such information might have been published in small-circulation magazines and was therefore available only to subscribers or members of the groups publishing the information. Internet publishing means the same information is now available to anybody with a browser, and the time and patience to seek it out. They do not need to be regular subscribers or dedicated activists.

The other revolutionary aspect of the Internet is the chat-room syndrome – the potential for individuals to communicate easily and perhaps

anonymously with others whom they may never meet but who have a shared interest. This global gossip can spread information swiftly, but like all gossip it is not necessarily accurate and is sometimes spiteful. Companies need to be aware of what is being said about them, and need to be in a position, through openness and transparency, to ensure that their reputations are protected from malicious or merely inaccurate messages.

- **Action** – the Internet is much more effective than the telephone at spreading messages quickly to a large number of recipients. This

makes it ideal for organising activities, which might encompass demonstrations, direct action and lobbying.

It has also opened up an entirely new risk – the risk of somebody hacking into corporate computers, disrupting systems and possibly destroying data.

While activism usually conjures up pictures of youthful demonstrators waving placards, the net has also spawned new forms of shareholder activism. In the USA, for example, the eRaider³ website aims to attract individual shareholders to the common cause of shaking up sleepy managements. The

organisation describes itself and its purpose in the following terms:

“eRaider is a true Internet confederation. Just by continuing to visit the site you join the cause. We fight for all individual shareholders whether we know you or not. If you support our efforts, you are one of us. Join us to pursue profit wherever our journey takes us, flying the battle flag of action against managers grown fat and sluggish on the backs of the very shareholders they are supposed to serve.”

Sites such as these can bring corporate governance more forcefully to the boardroom than a raft of regulations and worthy committees.

E-REPORTING

The Internet issues considered so far have been predominantly threatening to companies. There is also a more positive aspect, however, because the net makes it easier for companies to communicate just as it does for their critics. This can be a powerful tool in countering criticism for companies which are prepared to open themselves to outside scrutiny. For example, several companies⁴ have published social reports on the Internet. They

provide copious detail – much more than can be included in a conventional paper report – about the company’s relationship with stakeholders, ideally in terms which have been defined by stakeholders and with assessments by them rather than by the company. If such reports are independently verified, they provide an objective view of the company’s performance in geographic and business areas where they may be subject to criticism.

Such web-based reporting can be a powerful means of achieving transparency and dealing openly with controversial issues. It provides investors and

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campaigners alike with a means of accessing information easily which can help them to reach informed judgements.

E-VOTING

The most direct impact on corporate governance is likely to come from electronic voting. As discussed previously, the antiquated nature of Britain's system for share registration and voting is a serious impediment to expanding the number of votes cast at annual meetings. Changes under way, supported by legislation as a result of the Company Law Review, should sweep away this unsatisfactory state of affairs. It has been proposed that shareholder votes

should be allowed to be lodged electronically, and this would remove a key practical problem in current voting – the timescales involved and the potential for error in paper-based voting, given the lengthy chain from beneficial owner (e.g. pension trustees) to share registrar.

Computerised systems have made this process much more efficient than in the past and organisations exist to handle the voting process on behalf of the many participants in the chain. The most promising development was the launch in Spring 2000 by the National Association of Pension Funds of a comprehensive voting and monitoring service in conjunction

with one such operation – E-vote. Unfortunately E-Vote was closed down in early 2001.

Despite the availability of such services, voting levels remained relatively low. Overall, less than half the shareholders voted at meetings of the top 750 companies in 2000, and even in a handful of FTSE100 companies the voting level was below 25%. This emphasises the view of the Newbold Committee (see section 2) that a culture of non-voting in many institutions is a serious obstacle.

A change in the law to stimulate e-voting may help to change this culture, but the threat is growing

of government action to bring in compulsory voting to create acceptable shareholder participation.

NOTES

¹ See, for example, *Ethical Consumer, Myth or Reality?* Roger Cowe and Simon Williams, The Co-operative Bank, 2000.

² See, for example, GoodCorporation.com

³ See www.eraider.com

⁴ For example, BP, Shell, TXU Europe and United Utilities.

6

A boardroom for the twenty-first century

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Many boards were preoccupied during the 1990s with the new requirements of committees from Cadbury to Hampel, and eventually the Combined Code. All public company directors should now have come to terms with the more rigorous approach to boardroom practice which the corporate governance revolution has introduced. Now it is time to move on to embrace the wider issues which have been described in this booklet.

GENERAL APPROACH

The march of corporate governance has been accompanied by persistent complaints about the supposedly “tick-box” mentality which was being engendered,

which supposedly interfered with competitiveness and entrepreneurship. The criticism was that in specifying issues which must be addressed, the various Codes were encouraging boards to meet the letter of the law without necessarily incorporating its spirit into their actions, and were constraining companies from going about their legitimate profit-seeking activities. To some extent, this has been a valid criticism. But it is a criticism of the directors concerned and the approach of some institutional investors, rather than the corporate governance codes.

A code can only be as good as its implementation. The code itself

has to lay down specific requirements and make clear the general approach which is required. But it is those with responsibility for implementing the code who will determine whether it is applied effectively.

In the case of corporate governance, two groups have responsibility for implementation – company directors and those in financial institutions who own their companies’ shares. Both have a responsibility for interpreting and implementing the Combined Code intelligently. In both cases that means going beyond satisfying the specific requirements to ensure that the spirit of the law is being followed. Directors and investors

who are satisfied with ticking the relevant boxes are failing to implement good corporate governance. But it is nevertheless necessary to have boxes to tick. The objective should be to make that a starting point, not an end in itself.

Such a positive approach to corporate governance is entirely compatible with and supportive of responsible entrepreneurship. It would be foolish to suggest that corporate governance should not prevent any company doing anything it wants to do to make money. If that were the case there would be little point. But a proper corporate governance regime should prevent companies doing

only those things which are irresponsible and unacceptable – and ultimately bad for profits.

The main purpose of corporate governance, however, should be to make sure that the pursuit of profitable opportunities is carried out responsibly – it is more about the way things are done than what is done. That is why the Combined Code needs to be applied intelligently, along with a proactive approach to the wider social and environmental issues.

NON-EXECUTIVE DIRECTORS

In the twenty-first century boardroom, non-executive directors have a particularly important role. Formally they are directors of the

company with the same broad duties and responsibilities – and liabilities – as other board members. But under the Combined Code they also have a kind of supervisory duty, at least so far as corporate governance is concerned. They staff the audit committee, the remuneration committee and the nominations committee. Inside the boardroom, they must ensure that these committees and the board as a whole function properly. Outside the boardroom they should form essential links with the outside world – the City in particular, but other stakeholder groups as well. The need to understand the positions and needs of other stakeholder groups means that

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there are advantages in appointing people from outside the conventional business and City backgrounds.

To fulfil this role properly the modern non-executive must first and foremost be independent. That means independence in fact (no former executives or major shareholders, for example) but also independence of mind – the awareness and toughness to raise unwelcome ideas as well as objections to plans, projects and procedures which are backed by the executives but which conflict with the company's values and with its long-term interests. Independence should extend to an element of freedom from

conventional boardroom attitudes, emphasising the need to have directors from varied backgrounds.

TRAINING

There can be no doubt that being a director, especially of a public company, demands a special blend of skills, experience and understanding. It should not be expected that these characteristics will be present and well developed in new directors, whether from inside or outside the company.

Training is essential in the particular requirements of the boardroom – especially the corporate governance elements of directors' work. This is particularly true for the wider issues which

have been addressed here: the relationships between the company and stakeholder groups, the new activism of various stakeholders, the risks and opportunities in making or breaking reputation, the threats and potential in the electronic age. These are emerging issues which many executives may not have faced in their managerial careers, and many non-executives are also unlikely to have been exposed to them.

As well as ensuring those round the boardroom table are up to speed on these issues, directors will also need to consider the way such matters are handled outside the boardroom. Leadership from

the top is essential in changing values and pursuing corporate responsibility programmes, but such programmes obviously need to be carefully handled if they are to be effective. Companies have often found that the greatest resistance to new ideas of corporate responsibility has come from middle managers who are remote from the main challenges to conventional approaches and preoccupied with day-to-day challenges and targets. It is important in addressing corporate governance that it is seen as a challenge for the entire company, not merely for the boardroom.

STAKEHOLDER DIALOGUE

A company which understands the importance of stakeholder relations needs to engage seriously in dialogue with these groups. Reputational and relationship issues are serious business matters, so this is no less important than the conventional dialogue with financial institutions – the stakeholder group which dominates public company relationships.

Just as discussions with major shareholders helps a company understand how it is viewed in the City, and what these investors want, so dialogue with other stakeholders can be a crucial element in helping companies

understand what society expects from them.

Stakeholder dialogue means consulting the various groups affected by a company's actions. To be serious, and be taken seriously by these groups, it must be open and thorough. Dialogue should not begin with the board or executives deciding what questions are to be considered. The point is to start with a blank page and start to understand the issues which employees, environmentalists or others want to put on the agenda.

The first stage is therefore to discover the issues that each stakeholder group considers important. Once these issues have

A boardroom for the twenty-first century (continued)

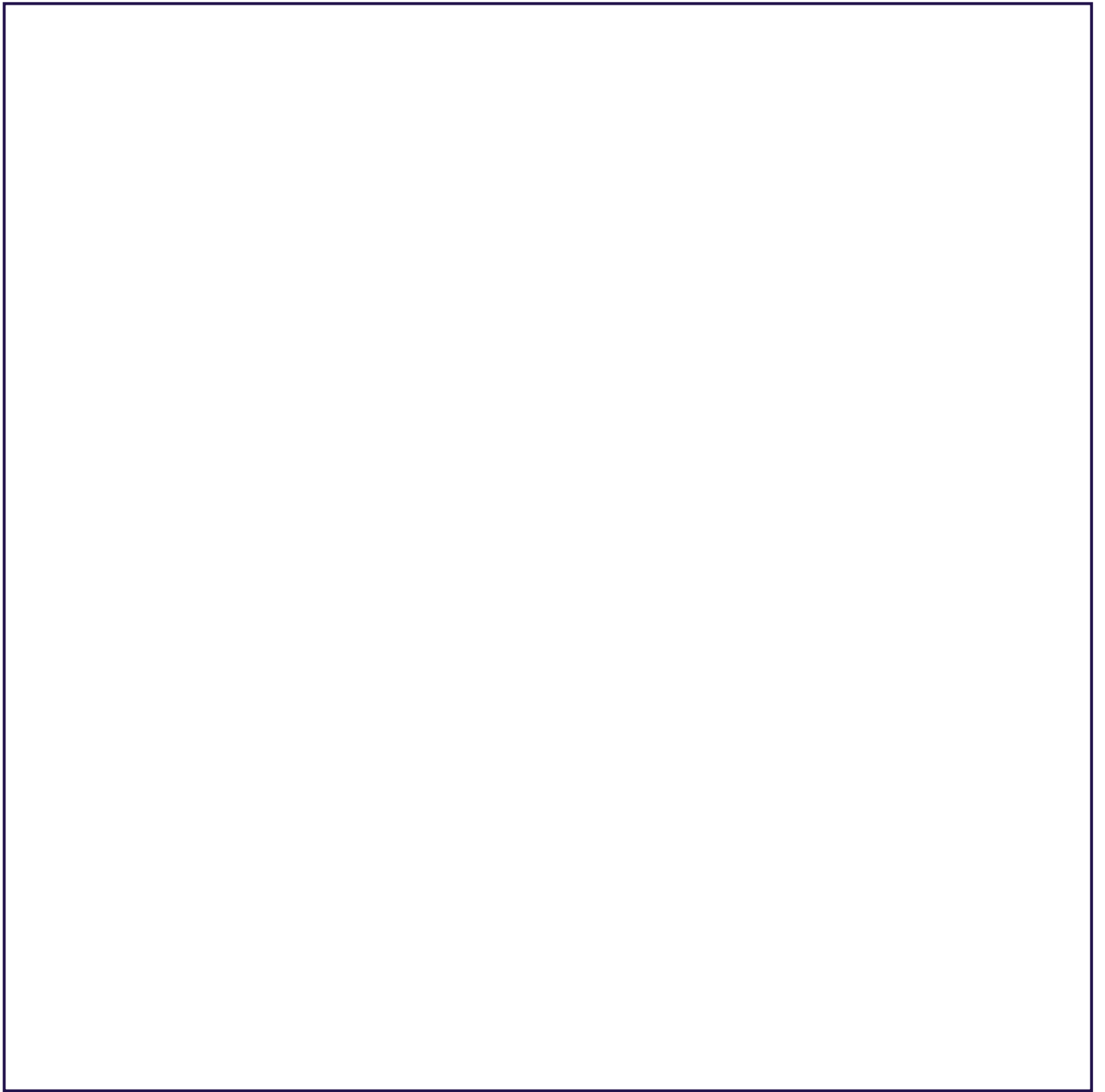
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been identified, each group can then be consulted to discover their judgements on the company's performance. This is not just an exercise in openness. It can also have more direct business benefits. Time and again companies that have gone through this kind of process have discovered that the process of talking to people whom managers would not normally engage with produces unexpected beneficial consequences. Almost inevitably it helps managers understand perspectives and values that are different from those they are usually exposed to.

There can also frequently be clear financial benefits from increased

staff motivation and improved corporate reputation. This is corporate governance in practice throughout the business, not just in the boardroom, delivering business benefits.

British boardrooms came a long way during the 1990s from what had in some cases been a cavalier attitude to directors' responsibilities. The current picture is far from perfect, for example, the issues of boardroom pay and shareholder voting remain unsatisfactory. But having addressed in detail the narrow responsibilities of directors, the next major challenge is to confront the wider responsibilities of companies.



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