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# CORPORATE GOVERNANCE

*principles, policies, and practices*

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BOB TRICKER

# Content Advisory Group

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# The Non-Financial Aspects of Corporate Governance

## Chapter Overview

- 7.1 New interest in the non-financial aspects of corporate governance
- 7.2 Corporate purpose and strategic reports
- 7.3 Corporate risk assessment and policies
- 7.4 The concept of Corporate Social Responsibility
- 7.5 CSR strategies and policies
- 7.6 Sustainability and ESG strategies and policies
- 7.7 Reporting non-financial aspects of corporate governance
- 7.8 Corporate culture and corporate ethics policies

## Learning Outcomes

On completion of this chapter, students will be able to:

1. Construct corporate reports.
2. Understand CSR, ESG, and sustainability.
3. Explain the significance of culture and corporate ethics.
4. Evaluate climate-related corporate strategies.
5. Contribute to the management of an entity's carbon footprint.
6. Discuss the global reporting initiative and sustainability reporting standards.

## 7.1 New interest in the non-financial aspects of corporate governance

When Adrian Cadbury wrote his voluntary (conform or explain) corporate governance code for the UK (Cadbury 1992), the annual **director's report** of most British listed companies consisted of a relatively brief directors' report, describing significant events and the company's performance that year, plus the required audited, **financial reports**. Cadbury titled his seminal report *The Financial Aspects of Corporate Governance*, because he realized there was much more to the subject, as already mentioned. Since the Cadbury Report was published, demands have grown for additional information, with a range of corporate reports covering some non-financial aspects of corporate governance, including:

- Corporate purpose and strategic reports
- Risk assessment and risk policies

- CSR strategies and policies
- Sustainability and ESG strategies and policies
- Corporate culture and ethics policies

The World Commission on Environment and Development was convened by the United Nations in 1983 and called the Brundtland Commission, after its chairman Gro Harlem Brundtland. The Commission was created to address growing concern 'about the accelerating deterioration of the human environment and natural resources and the consequent threat that deterioration for economic and social development'. The Commission defined sustainable development as 'development that meets the needs of the present without compromising the ability of future generations to meet their own needs'. None of these topics featured in Cadbury's report, but they have all influenced governance thinking and practice. We explore each of them in this chapter.

## 7.2 Corporate purpose and strategic reports

### Corporate purpose

When the joint-stock, limited-liability company was invented, in the mid-nineteenth century, states insisted on tight rules before they granted the privilege of limiting shareholders liability for the debts of the company. Each company's memorandum of association had to define its purpose (for example, build a railway from A to B, or provide a water supply to a given area).

Over the years, however, lawyers widened the purpose clause to include more and more possible activities. These statements of corporate purpose became so wide that they no longer defined the company's purpose and, indeed, some legislatures dropped the need for a purpose clause in the memorandum of association.

Nevertheless, boards still need to identify the aims of their company, establish its mission, and set its values, if the organization is to understand what it is about and the outside world to know its purpose.

### Corporate Governance in Action 7.1 Rolls-Royce

The importance of a statement of corporate purpose can be seen in the two Rolls-Royce companies. The official statements of purpose<sup>1</sup> published by Rolls-Royce Holdings and Rolls-Royce Motor Cars. The official statements of purpose for each company are as follows:

#### Rolls-Royce Holdings PLC

Rolls-Royce Holdings PLC (Rolls-Royce) designs, develops, and manufactures power and propulsion systems. The company's product portfolio comprises aircraft and helicopter engines, combat jet engines, unmanned aerial vehicle engines, and nuclear reactors. It also develops, manufactures and markets naval engines, submarine nuclear power plants, small modular reactor and new electrical power solutions. Rolls-Royce serves civil and defence aerospace, naval, submarines, land, defence

<sup>1</sup> The statement of purpose for each company has a web address of over 30 words, mapped to a reference here. For further information use Google to access the official website of each company.

services, advanced technology, marine, power, and nuclear energy markets. Rolls-Royce markets its products under the MTU brand name. The company's business operations span across the Americas, Asia, Europe, the Middle East, and Africa. Rolls-Royce is headquartered in London, UK. The company has more than 50,000 employees.

### Rolls-Royce Motor Cars Ltd

Rolls-Royce Motor Cars Ltd is a wholly-owned subsidiary of the BMW Group. The company is the world's leading luxury manufacturer based at The Home of Rolls-Royce at Goodwood, near Chichester, West Sussex, which comprises its global headquarters and Global Centre of Luxury Manufacturing Excellence—the only place in the world where Rolls-Royce motor cars are hand-crafted. The company has around 2000 employees.

### Background to the two companies

Originally founded in 1906, Rolls-Royce Ltd was nationalized in 1971, becoming Rolls-Royce 1971 Ltd, initially including the Motor Car Division. The Motor Car Division was floated as a separate company in 1973, and became Rolls-Royce Motors Holdings Ltd, which traded as Rolls-Royce Motors. Rolls-Royce 1971 Ltd was privatized in 1987, becoming Rolls-Royce PLC.

Production at Rolls-Royce Motor Cars Ltd began on 1 January 2003 with the world's pinnacle luxury product, Phantom. The range has since expanded to include Ghost, Wraith, Dawn, Cullinan, and their Black Badge counterparts. The company has customers in more than 50 countries with a network of Rolls-Royce dealerships.

The financial accounts required by companies' legislation, accounting standards, and stock-market listing rules include a **profit and loss account** and a **cash flow statement**, which show the financial performance over a given period, and a **balance sheet**, which depicts the financial situation at a given time. What actual or potential investors, employees, customers, and competitors want to know about the company are its purpose, prospects, and plans. In other words, they want to know about the company's future. Similarly, financial analysts, credit agencies, the media, and an interested public also want information about a company's prospects and risks. Unfortunately, traditional financial accounts do not provide this information. The directors' **annual report** and the **strategic report** are intended to provide it.

### The annual report

According to the UK Financial Reporting Council (FRC, 2022a), the annual report should provide the information to assess the entity's position and performance, its business model, and the corporate strategy. In particular, the annual report should include information on the entity's:

- development, performance, and position
- prospects
- strategy for achieving the objectives
- business model
- governance
- directors' remuneration

### The strategic report

The strategic report extends the information on strategy and the business model in the directors' annual report. It discusses, in more detail, how the entity creates value through its business model and **strategic management** process. It expands on the entity's **strategic environment**. In the modern world, every entity faces many uncertain future events generated by, among other things, **geopolitical**, national, and local political events, economic developments, social changes, catastrophes, and competitor activities. However, no company in a competitive environment is going to describe its detailed strategic thinking to competitors, any more than an admiral discloses the fleet's position and tactics to the enemy.

Some strategic reports discuss the entity's risk profile and policies. Other entities present **assessment** and risk policies in a separate risk report.

The strategic report should provide a textual context to amplify and support the financial information in the published financial accounts. Clearly, it is essential that the textual material is entirely consistent with the financial. A strategic report can also include the potential value of assets, such as research projects, **intellectual property**, training programmes, recent mergers and acquisitions, and investments in fixed assets that are not reflected in the financial accounts. A strategic report can also help to demonstrate how the entity relates to its contractual stakeholders—its employees, customers, suppliers, and sources of **non-equity finance**.

Although the information in a strategic report is likely to be developed by the CEO and the management, it is a report from the board, and it is essential that all board members concur with its contents.

In the UK, the Companies Act (2006) and subsequent regulations require all listed companies and large and medium private companies to provide a strategic report. Similarly, the Limited Liability Partnership Act (2000) requires large **limited liability partnerships (LLPs)** to publish a strategic report. The **FRC** provides guidance on the preparation of a strategic report.<sup>2</sup> We will discuss the US Securities and Exchange Commission (SEC) requirements to corporate reporting of both financial and non-financial matters later in this chapter.

### 7.3 Corporate risk assessment and policies

Many of the early corporate governance codes, including the Cadbury Report (1992), said little to say about the board's responsibility for risk policies. Cadbury mentioned risk only in the context of boards' responsibility for avoiding internal financial fraud, although in fact Cadbury always emphasized that his report was about the financial aspects of corporate governance and did not cover the whole subject.

The global financial crisis in 2008 drew attention to the need for boards to recognize the significance of risk and their responsibility for risk assessment, policies, and reporting. On some boards, this was a new experience (see e.g. Case study 4.2 The collapse of Northern Rock bank).

<sup>2</sup> [www.frc.org.uk/accountants/accounting-and-reporting-policy/clear-and-concise-and-wide-corporate-reporting/narrative-reporting/guidance-on-the-strategic-report](http://www.frc.org.uk/accountants/accounting-and-reporting-policy/clear-and-concise-and-wide-corporate-reporting/narrative-reporting/guidance-on-the-strategic-report)

Actual and potential investors, employees, customers, suppliers, as well as financial analysts, credit agencies, the media, and an interested public, wanting to understand a company's potential, all need to assess the company's risk profile. A sound risk report provides insights into the nature and extent of risks facing the company and helps users appreciate the true value of the company.

The subject of risk assessment, risk policies, and risk reporting has now become such a significant part of corporate governance that the whole of Chapter 11 is devoted to the topic.

### 7.4 The concept of Corporate Social Responsibility

CSR (Corporate Social Responsibility) was an acronym frequently found in corporate governance writing in the late twentieth and early twenty-first centuries. A primary focus was on the behaviour of profit-orientated companies and raised questions about the role and legitimacy of corporations in society.

#### Questioning the societal legitimacy of corporate entities

The question was neatly posed by Milton Friedman (as discussed in Chapter 6)—'What is the purpose of the corporation?' His view was that the only legitimate purpose for a company was to create wealth, pursuing its business effectively for the benefit of its customers while providing a profitable reward to its owners—the investors. It was the role of the state, he believed, to provide the legal framework that regulated companies' behaviour in relation to the rest of society.

Carroll (1979) attempted to answer Friedman's question by suggesting that corporate responsibility has four levels:

1. **economic responsibility**: first and foremost, the social responsibility to be profit-orientated and market-driven
2. **legal responsibility**: to adhere to society's laws and regulations as the price for society's licence to operate
3. **ethical responsibilities**: to honour society's wider social norms and expectations of behaviour over and above the law in line with the local culture
4. **discretionary (or philanthropic) responsibilities**: to undertake voluntary activities and expenditures that exceed society's minimum expectations

Mervyn King, author of the South African corporate governance codes, commenting about his fourth report noted:

that report revolutionised approaches to corporate governance around the world because it said that in the decision-making process you should take account of the legitimate needs, interests, and expectations of stakeholders linked to the company. That did not mean that directors should be accountable to stakeholders, but that they should take account of stakeholder needs and expectations in their decision-making. [Companies should] still act in the best interests of the company through the maximization of the total economic value.<sup>3</sup>

<sup>3</sup> Interview in CSJ (2010), Hong Kong Institute of Chartered Secretaries, December.

However, although King's perspective has been widely promoted, the concept has its detractors. Anne Bernstein (2010), head of a South African think tank, pointed out that developing nations need more companies that generate wealth, not demands to pursue social responsibilities. In South Africa, where many are jobless and live in poverty, people need work. Bernstein said, not rules designed to protect those already in work, which can reduce the number of available jobs, nor environmental demands, which have delayed projects to replace eroding shacks with new houses.

As Kofi Annan said, when Secretary-General of the United Nations:<sup>4</sup>

We have to choose between a global market driven only by calculation of short-term profits and one which has a human face; between a world which condemns a quarter of the population to starvation and squalor, and one which offers everyone at least a chance of progress in a healthy environment; between a selfish free-for-all in which we ignore the failures of losers, and a future in which the strong and successful accept their responsibilities; between a global vision and leadership.

As we saw in the discussion of stakeholder philosophies in Chapter 6, the debate continues about companies' responsibilities to their shareholders and other stakeholders. Such concerns led to the focus on CSR.

### Perspectives of corporate social responsibility

Broadly, CSR is about corporate entities acting as good corporate citizens. But although intuitively obvious, CSR has acquired a range of meanings, which overlap yet focus on different aspects of the topic. Consider the following, alternative points of view:

#### The societal perspective

This view holds that companies have social responsibilities beyond just obeying the law and paying their taxes, because their activities have an impact on society. A commitment to CSR recognizes that companies should be accountable not only for their financial performance but also for their impact on society. The definition used by Business for Social Responsibility, a not-for-profit organization based in San Francisco, is:

CSR involves operating a business in a manner that meets or exceeds the ethical, commercial, and public expectations that society has of business.

But such thinking is not universally accepted. Robert Reich (2006), who was previously a CSR advocate, argued that consumers today have a world of choice and businesses face more competition than ever before. In pursuit of corporate performance, he believes, a CEO's incentives become aligned with shareholders' interests so they 'slash payrolls, outsource abroad, and drain our main streets of shops'. Reich concluded that if states want to avoid adverse social consequences, they need to pass laws.

<sup>4</sup> At the World Economic Forum, Davos, on 31 January 1999.

#### The strategy-driven perspective

This perspective starts from the proposition that businesses' social responsibility is an integral part of the wealth-creation process. A company runs in a socially responsible way because its CSR strategies and policies are business-driven, in both the short and long term. Such companies make a solid business case for their CSR policies based on cost-effective criteria. All corporate strategies—research, exploration, product development, production, marketing, human resources, and financial—are contingent on the CSR objectives. The business case for taking such an approach to corporate governance is that it enhances competitiveness, increases customer satisfaction, improves employee relations, reduces the **cost of capital**, and enhances shareholder value, while also investing in communities and increasing wealth creation in society. Critics have argued that strategy-driven CSR distracts from the fundamental economic role of business, although studies have shown a positive correlation with improved shareholder returns, albeit a small one. This approach to CSR is found in many European boardrooms and, increasingly, in the US.

#### The stakeholder perspective

Companies with this perception see CSR as the alignment of corporate values and actions with the expectations and needs of their stakeholders—shareholders, customers, employees, suppliers, communities, regulators, other interest groups, as well, as society. Their CSR policies describe the company's commitment and responsibility to its stakeholders. Adopting this perspective, the European Commission has defined CSR as:

a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis.<sup>5</sup>

If companies fail to achieve acceptable CSR standards, costs can be incurred such as legal damages, restitution costs, lawyers' fees, or product recalls. The loss of reputation can be even higher, affecting sales, costs, and employee turnover. Investigative media increasingly report cases of firms **transgressing** accepted CSR behaviour—for example, in the employment of children in the fields and factories in developing countries, the alleged ill-treatment of animals in testing pharmaceutical products, and pollution in the oil drilling and transport industries, even though such practices may be legal in the places where they occur.

#### The ethical perspective

The ethical viewpoint sees that corporate entities, like individuals, have an obligation to act for the benefit of society of which they are a part, contributing to society while doing no harm. A wide range of laws and guidelines that steer and control corporate behaviour already exist at state, national, and global levels on health and safety, human rights, and environmental issues. But ethical CSR activity needs to go beyond what is required by these basic standards. A board of directors needs to be the conscience of the company—responsible

<sup>5</sup> Brussels, 18 July 2001 GREEN PAPER Promoting a European framework for Corporate Social Responsibility.

for establishing its corporate values. Ethical codes, understood throughout the organization, reflect the directors' own behaviour. An ethical standpoint is likely to produce voluntary CSR policies that go well beyond the requirements of laws and guidelines.

### The political perspective

Interest groups, some with an anti-business agenda, argue that CSR is no more than vested self-interest at best and a public relations **window-dressing** exercise at worst. Some have called for legislation to impose standards of CSR on companies, particularly **multinational**. The response from the Confederation of British Industry (CBI) was that CSR should remain market-driven and voluntary. Attempts to raise standards, the CBI believes, would remove the competitive incentive that drives CSR activity and would place an unmanageable burden on companies, particularly small and medium-sized firms. CSR policies should reflect the companies' activities and the context in which they operate, while legislation in this area would constrain business activity and reduce CSR to a levy, the CBI said.

Other commentators have argued that companies do not have a mandate to pursue broader, social goals. Such activities should be pursued by governments acting for their citizens. Some business leaders concur, feeling that their companies are not equipped to pursue broader social goals.

The ongoing debates, in advanced countries around the world, about the regulation of artificial intelligence, or the responsibilities of information platforms, such as Facebook, Google, or TikTok, provide insights into this perspective.

### The philanthropic perspective

For many years, some companies have sought to 'put something back' into the society that provided them with customers, employees, and success. Such corporate philanthropy may involve charitable giving to support communities, charities, or other causes. In more recent years, it has included corporate services, such as employees' time. The Commission of the European Union has defined such an approach to CSR as 'a concept whereby companies decide voluntarily to contribute to a better society and a cleaner environment'. But a philanthropic approach to CSR is essentially peripheral to the main business. When times get hard, it is also one of the easiest expenditures to cut.

CSR is widely recognized as part of companies' corporate governance responsibilities. CSR practices vary between countries and cultures. Different value systems, different economic conditions, and different social priorities mean that 'one size cannot fit all'.

## 7.5 CSR strategies and policies

To be effective, a company's CSR efforts need to be led by the board and embedded in the corporate strategy. This will lead to CSR policies, for approval by the board. Basically a CSR policy determines how the company engages with its shareholders and the other stakeholders, including its employees, customers, and suppliers, the communities in which it operates, and society generally.

A clear CSR policy may influence potential investors looking for socially responsible, ethical, or environmentally friendly enterprises in which to invest. Successful CSR policies can also influence employees and potential employees. Some younger people make CSR policies an employment criterion. CSR policies also influence management decisions at all levels and penetrate all aspects and every level of a firm's activities.

If they are to be effective, CSR policies should be understood, accepted, and applied throughout the organization. They also need to be reviewed regularly to reflect changing business, economic, and social situations.

Prior to 2006, company law in the UK required directors to act in the best interests of the company, which effectively meant in the long-term interest of the shareholders—in other words, by attempting to maximize shareholder value. But the Companies Act 2006 (section 172) specifically spelt out a **statutory duty** to recognize the effect of board decisions on a wider public. For the first time in UK company law, CSR responsibilities were included among the formal duties of company directors:

A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard to:

- The likely consequences of any decision in the long term
- The interests of the company's employees
- The need to foster the company's business relations with suppliers, customers, and others
- The impact of the company's operations on the community and the environment
- The desirability of the company maintaining a reputation for high standards of business conduct, and
- The need to act fairly, as between members of the company

Thus, UK company law now required companies to consider employees, suppliers, customers, and other business partners, as well as the community and the environment, in their decisions.

A CSR consultant, who was retained by a manufacturing company to advise on its CSR policies, proposed the policy statement in Corporate Governance in Action 7.2.

### Corporate Governance in Action 7.2 Extract from the CSR policy of a manufacturing company

For continuing economic success, all company strategies, policies, and management decisions should take account of their long-term effects and impact on the following:

- All company stakeholders including:
  - suppliers and others in the upstream supply chain
  - agents, distributors, and others in the downstream delivery chain
  - customers of the company's end products and service
  - creditors
  - non-equity sources of finance

- employees at all levels, including part-time and contract employees
  - pensioners in the company's pension fund
  - **self-employed contractors** to the company
2. All the communities in which the company operates including:
- local communities
  - regional communities
  - national communities
  - international communities
3. The environment
- Consider all the relevant communities, regions, and countries affected by the company's manufacturing and distribution chain, including possible effects of:
- our production activities, such as:
- energy use
  - **depletion of resources**
  - **exploitation of labour**
  - pollution
- our products and services, including:
- the effect of the product in use
  - energy use
  - health or other risks
  - pollution
- the final disposal of the product, including:
- energy use
  - pollution

Each of these broad policy statements is further amplified in the company's CSR handbook.

### The CSR competency framework

To encourage commitment to CSR practices, the UK Government created a CSR competency framework—a flexible tool, which is offered as a 'way of thinking' for companies of all sizes. The framework offers six core characteristics, with five levels of attainment for each.

1. *understanding society*: a knowledge of how the business operates in the broader societal context and a knowledge of the impact that the business has on society, plus a recognition that the business is an important player in society, seeking to make that impact as positive as possible
2. *building capacity*: working with others to build the capability to manage the business effectively, helping suppliers and employees to understand your environment and to address social and environmental concerns in their day-to-day role

<sup>6</sup> [www.nmiconsulting.co.uk/docs/Competency\\_Framework\\_FINAL.pdf](http://www.nmiconsulting.co.uk/docs/Competency_Framework_FINAL.pdf)

3. *questioning 'business as usual'*: constantly questioning your business in relation to a more sustainable future and being open to improving people's quality of life and the environment, acting as an advocate, engaging with bodies outside the business who share this concern for the future
4. *stakeholder relations*: recognizing that stakeholders include all those who have an impact on, or are impacted by, your business, understanding the opportunities and risks they present, and working with them through consultation, taking their views into account
5. *strategic view*: ensuring that social and environmental concerns are included in the overall business strategy so that CSR becomes 'business as usual', with leadership coming from the top and resulting in everyone in the business having an awareness of the social and environmental impacts in their day-to-day roles
6. *harnessing diversity*: recognizing that people differ and harnessing this diversity, reflected in fair and transparent employment practices, promoting the health, well-being, and views of staff with everyone in the business feeling valued

The five levels of attainment are:

1. *awareness*: the broad application of the core CSR characteristics and how they might impinge on business decisions
2. *understanding*: a basic knowledge of some of the issues, with the competence to apply them to specific activities
3. *application*: the ability to supplement this basic knowledge of the issues, with the competence to apply it to specific activities
4. *integration*: an in-depth understanding of the issues and an expertise in embedding CSR into the business decision-making process
5. *leadership*: the ability to help managers across the organization in a way that fully integrates CSR in the decision-making process

Overall, the intention of the CSR framework is to change employees' mindsets and to promote an appropriate CSR strategy throughout the organization and between the company and its stakeholders. Creating a strong CSR culture throughout an organization needs to be part of an ongoing performance assessment of both organizational units and individuals and should not be allowed to become a form-filling exercise.

An organization's response to its social and environmental impacts, recognized through CSR awareness, can provide a cost-effective, yet comprehensive, way of managing social and environmental risk across an organization. However, corporate groups operating in different parts of the world may find it difficult to achieve homogeneous CSR policies throughout the group.

### Enlightened shareholder value (ESV)

Boards adopting an investor-driven **ESV** approach believe that the satisfaction of the needs of all stakeholders is crucial to corporate success, that it is essential to creating value for shareholders. The **ESV** concept of corporate governance attempts to overcome apparent conflicts between a shareholder-focused and a stakeholder-focused approach that we saw in corporate governance theory, in Chapter 6. An **ESV** perspective suggests that profits are

generated, shareholder value created, and society's well-being increased by satisfying stakeholder interests, rather than through the classical attempts of shareholder theory to maximize shareholder wealth.

### Meeting changing expectations

The World Business Council for Sustainable Development (WBCSD) is 'a global, CEO-led community of over 200 of the world's leading sustainable businesses with 20 million employees and \$8.5 trillion in combined revenue' (Holme and Watts, 2000).

In its first report on CSR, 'Meeting Changing Expectations' (1999), the WBCSD suggested that:

- CSR priorities today are human rights, employee rights, environmental protection, community involvement, and supplier relations
- companies should articulate their own core values and codes of conduct, or failing that, endorse and implement codes produced by others

The report added that:

- a coherent CSR strategy, based on integrity, sound values and a long-term approach offers clear business benefits to companies and a positive contribution to the well-being of society
- a CSR strategy provides the opportunity to demonstrate the human face of business
- such a strategy requires engagement in open dialogue and constructive partnerships with government at various levels, intergovernmental organizations, non-governmental organizations (NGOs), other elements of civil society, and local communities
- in implementing their CSR strategies, companies should recognize and respect local and cultural differences, while maintaining high and consistent global standards and policies; and
- being responsive to local differences means taking specific initiatives

Today, WBCSD is working to accelerate moves to reach the global target of **net-zero carbon** as we will discuss later in this chapter.

### The United Nations Global Compact

The UN Global Compact<sup>7</sup> is a strategic initiative for businesses that commit to aligning their strategies and policies with ten universally accepted principles (The Ten Principles) in the areas of human rights, labour, the environment, and anti-corruption.<sup>8</sup> The Compact calls for participating companies to accept a set of core values.

These values were derived from the Universal Declaration of Human Rights, the International Labour Organization's Declaration of Fundamental Principles and Rights at Work, and the UN Convention against **Corruption**.

<sup>7</sup> [www.unglobalcompact.org](http://www.unglobalcompact.org)

<sup>8</sup> [www.globalreporting.org](http://www.globalreporting.org)

The Ten Principles of The United Nations Global Reporting Initiative are:

#### Human Rights

Principle 1: Businesses should support and respect the protection of internationally proclaimed human rights

Principle 2: Make sure that they are not complicit in human rights abuses

#### Labour

Principle 3: Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining

Principle 4: The elimination of all forms of forced and compulsory labour

Principle 5: The effective abolition of child labour

Principle 6: The elimination of discrimination in respect of employment and occupation

#### The environment

Principle 7: Businesses should support a precautionary approach to environmental challenges

Principle 8: Undertake initiatives to promote greater environmental responsibility

Principle 9: Encourage the development and diffusion of environmentally friendly technologies

#### Anti-corruption

Principle 10: Businesses should work against corruption in all its forms, including extortion and bribery

### Does sound CSR lead to better performance?

A question frequently asked is whether there is a link between CSR and economic performance. Although research studies have been conducted, a basic problem has been how to measure CSR. Some studies have also been marred by an ideological bias or limited methodology. Although a few studies have shown some correlation between firms' CSR and their financial performance, current research does not point to a decisive link. However, the longer-term effects of a sound CSR reputation in both the consumer and employment markets and the stock market may well persuade boards of the importance of CSR efforts.

Some firms have claimed that their CSR policies and reports have:

- improved board decision-making
- made the firm more attractive to existing and potential employees
- improved top management and board-level strategic thinking and decisions
- produced innovations in the way in which the firm operates
- responded to customers' demands
- met stakeholders' and society's changing expectations

For such reasons, many firms approach CSR as enlightened self-interest. However, few claim a demonstrable positive correlation between good CSR practices and corporate financial

In its ten-page Strategic Report,<sup>2</sup> Sainsbury's, a UK retailer, explains its vision and values (see Corporate Governance in Action 8.2):

### Corporate Governance in Action 8.2 Extract from Sainsbury's Strategic report

#### Our values make us different

Our values are integral to how we do business, and they enable us to help our customers to live well and drive lasting, positive change in communities across the UK and overseas. They help us grow trust with our stakeholders, as we work closely with our partners to build a more sustainable future.

#### Making the difference

Our Sustainability Plan is structured around our values and is our guide for building a more sustainable future. Working closely with our partners, we focus our efforts where we can make the greatest difference.

#### Sainsbury's underlying values

- Living healthier lives
- Making a positive difference to our community
- Sourcing with integrity
- Respect for our environment
- Great place to work

Sainsbury's Strategic Report gives explicit examples of how these broad underlying values are achieved in practice.

Sainsbury's statement of values focuses on customers, communities, stakeholders, and partners, emphasizing trust, which seldom features in corporate governance statements, though is an integral part of our definition of the corporate governance. It also emphasizes a commitment to sustainability in keeping with the interest in the subject shown in the previous chapter.

### Corporate Governance in Action 8.3 Microsoft's Mission Statement

Microsoft's current statement of its corporate mission<sup>3</sup> is:

To empower every person and every organization on the planet to achieve more

Critics of the Microsoft Mission Statement suggest that it is too bland, too all-embracing, to provide a useful insight into the company's purpose, vision, or values. Other commentators, however, commended its insight into both the company's values (empowerment of people and organizations) and its target markets (everyone and every organization on the planet).

Previous statements of Microsoft's Mission and Values had been more informative:

At Microsoft, our mission and values are to help people and businesses throughout the world realize their full potential. We consider our mission statement a commitment to our customers.

<sup>2</sup> [www.about.sainsburys.co.uk/~media/Files/S/Sainsburys/sainsburys-ar2019-values.pdf](http://www.about.sainsburys.co.uk/~media/Files/S/Sainsburys/sainsburys-ar2019-values.pdf)

<sup>3</sup> Source: Microsoft website.

We deliver on that commitment by striving to create technology that is accessible to everyone—of all ages and abilities. Microsoft is one of the industry leaders in accessibility innovation and in building products that are safer and easier to use.

As a company, and as individuals, we value integrity, honesty, openness, personal excellence, constructive self-criticism, continual self-improvement, and mutual respect. We are committed to our customers and partners and have a passion for technology. We take on big challenges, and pride ourselves on seeing them through. We hold ourselves accountable to our customers, shareholders, partners, and employees by honouring our commitments, providing results, and striving for the highest quality.

Some directors feel that their mission (or vision) statement provides a concrete description of their company's purpose, values, and direction, which guides strategic decisions, inspires employees, and informs customers and other stakeholders. Such mission statements need to be a clear, but succinct, indication of the core purpose and values of the enterprise.

Other directors, however, feel that written mission statements can be at best a bland public relations exercise and at worst an exercise in futility. Certainly, unless directors believe in and link their mission with their strategic decisions, a public mission statement becomes little more than a marketing slogan or a sign on the wall for employees.

#### Who formulates corporate strategy?

What does strategy formulation involve? One of the primary duties of every board is to ensure that its enterprise is heading in the right direction. The board that lacks a shared view of their entity's purpose and future direction cannot develop an effective corporate strategy. Strategy formulation is the process of generating and reviewing alternative longer-term directions for the enterprise that lead towards the achievement of its purposes, consistent with the risk profile acceptable to the board.

Who is responsible for formulating strategy? Boards vary in their involvement in the strategy formulation process. In a board with a majority of executive directors, as in many small entities, family companies, and in some subsidiary companies, the board is likely to be heavily involved in the strategy formulation process because many of the directors are 'wearing two hats' as both manager and director. Consequently, they can contribute to the strategic discussions directly from their own knowledge and experience of the business. The challenge to boards dominated by executive directors is that they are 'marking their own examination papers', and might lack a critical perspective. On such boards, non-executive directors can play a vital role, offering alternative insights, raising important questions, for example about risks involved, and by challenging conclusions. Advice from senior managers, who are not on the board, external consultants, and other experts can also add important dimensions to strategic thinking.

By contrast, in a board with a majority of independent outside directors, as in most large US and UK listed companies, strategy is typically driven by top management—the CEO and the management team. What then is the role of the board? Can non-executive directors, who are independent of the company and its business, really know enough about the company and its industry to make a realistic contribution to strategic thinking? Some also question

whether they can find sufficient time to make a worthwhile input to strategy, particularly since some of them may be CEOs or chairs of companies in their own right. Typically, in such situations, the CEO with the top management team undertakes a strategic review and produces a set of strategic proposals for the board's approval. The independent directors then question, challenge, and maybe refer the strategies back for further work, before giving their approval. Independent directors can make a significant contribution, drawing on their experience in other companies and industries, using their professional skills, and applying strategy formulating experience in other situations.

### Long-range planning

How is strategy formulated? A formal approach to strategic planning, still adopted by a few companies, is the creation of a long-range plan. Essentially, long-range planning extends the annual budgeting process over a longer strategic time horizon, perhaps three, four, or five years. At least this approach forces boards to focus on the longer term. But the drawbacks are apparent. The planner is, conceptually, inside the organization looking out. The approach fails to take a strategic perspective, perpetuating the existing business, rather than focusing on its strategic context, recognizing strategic changes in customer demands, markets, competition, technology, supply chain issues, and financing. It also ignores changes in the economic, political, or societal context.

### Strengths, Weaknesses, Opportunities, Threats (SWOT) analysis

A more penetrating approach to strategic analysis, that is still widely used, is **SWOT analysis** (Strengths, Weaknesses, Opportunities, and Threats), which seeks to relate the internal situation in the firm to its external strategic context.

The SWOT analysis undertaken by a UK estate agent (realtor) is given in Corporate Governance in Action 8.4. The strategic insights were generated using a half-day strategic workshop, run by a consultant and attended by the directors and top management from the firm's head and regional offices.

#### Corporate Governance in Action 8.4 SWOT analysis for a long-established estate agent (realtor)

The conclusions of a strategy workshop, attended by key personnel in the organization, were charted as follows:

##### Strengths

- A well-known and respected brand name
- A good **market share** where we are represented
- We have been successful for 35 years

- Both sellers and buyers respect our business methods
- Our website, leaflets, and adverts for promoting properties are successful
- A large and experienced staff
- A reputation as a good employer
- Effective financial and **management control systems**

##### Weaknesses

- Competition from internet-based agencies with no agency offices
- High **overheads**, particularly rents and salaries
- Overheads rising
- **Cash flow** erratic
- Slow to respond to new clients—pressure of work
- Insufficient time with clients
- Higher management authority required for decisions—slows the contract process and stifles staff initiative
- Our website is still being improved
- Telephone inquiries not well handled
- **Staff turnover**—experienced staff being poached
- **Organizational inertia**—slow to change direction—overconfidence

##### Opportunities

- Our business sector is expanding—growth in sales of new house builds and existing properties
- Commercial property sector sales not yet in portfolio
- Many opportunities for development of new client services
- Our competitors may be slow to adopt new technologies

##### Threats

- Competition rife—internet agencies, national franchised chains, private sales
- Vulnerable to internet—developments unpredictable
- New ways to buy and sell houses erodes our position
- Developments in technology change the basics of the business
- A new strategy by a large competitor ruins our market position
- More government controls and charges on property transfers

The strategic situation facing the firm, both internally and externally, is certainly highlighted by this analysis. What emerges is a picture of a long-established, successful, but over-bureaucratic firm in the real-estate business facing vulnerability in an increasingly competitive market, which is being driven by franchised chains and a shift towards marketing via the Internet. The self-confidence rooted in past success, the difficulty of adapting to change, and the need to develop a sense of urgency for strategic change are apparent.