THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

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Sustainability and corporate reputation

Key points from a Centre for Business Performance roundtable

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Thought leadership from the Institute…

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Thought leadership from the Institute…

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A definition of sustainability

'…to meet the needs of the present without compromising the ability of future generations to meet their own needs.'

United Nations World Commission on Environment and Development (The Brundtland Commission) Our Common Future, 1987

Modern business has placed new pressures on companies, both large and small. It is no longer enough for companies to be profitable. They must be sustainable in the long term, and that demands a healthy corporate reputation and good corporate governance as well as strong financial performance. The Centre for Business Performance's roundtable, held earlier this year under the chairmanship of the then President, Graham Ward at Chartered Accountants' Hall, illustrated that corporate reputation and sustainability is firmly on the business agenda. But how can sustainability be encouraged, measured and enforced? Senior members of NGOs, the business, academic and investment community were represented and this paper summaries the discussions, which were held on Chatham House terms.

Introduction

Sustainability has always been a crucial issue for company boards. The role of the board is to ensure the continued existence of the company in the long term. In that sense, sustainability has always been with us. It is our understanding of sustainability that has altered. A sustainable business today is one that is conducted both profitably and responsibly, but is also durable over the long term.

Modern business and technology has brought new pressures for large and small organisations.

Globalisation has given companies access to many more markets but, at the same time, it has reduced the opportunities for carrying on business in traditional ways. There is no hiding place for companies that do not subscribe to transparency, ethical behaviour, good governance and sustainability. The internet has opened up the world. Anecdotes and facts about corporations can travel the world at the touch of a button – whether they are true or not. If just one individual is dissatisfied, they can tell billions of others. In such a world it is very difficult indeed for a company to fight back.

I used to think that I worked for a company that spent £2.5bn a year on research, developing brilliant new drugs to keep people alive, kill disease and generally add to the sustainability of human life. If I read the press, it seems instead that I work for a company that denies drugs to Aids victims in Africa and pollutes water. It is difficult to reconcile.

Technological developments have made it more important than ever for companies to protect their corporate reputation. At the same time, stakeholders have begun to demand strong ethical and environmental behaviour from the companies they invest in and the companies that employ them.

Sustainability is recognised as much more than just a word. It is something that must be a way of life. It is not enough for companies to say that they subscribe to the principles of sustainability. 'Greenwash' – bland statements on environmental and ethical issues – is not enough to meet the growing demands of investors.

The fact is that people are getting bored and disillusioned by simple lists of platitudes.

Companies recognise that their customers and employees do care about sustainability, as do a small but growing band of investors.

Investors, ethics and sustainability

Historically, investors have not been very interested in sustainability issues. They have a tight focus on earnings and are not always imaginative about where long-term issues such as sustainability might drive those earnings. The one exception is socially responsible investors. They subscribe to sustainability and recognise that a loyal customer base and a loyal employee are the real mark of value as far as the company's continuing existence is concerned.

Nevertheless, recent years have seen a marked change in the opinions of both investors and markets. A series of initiatives and events has steadily brought sustainability issues into the spotlight:

- A change in the Pensions Act required all pension funds in the UK to state the extent to which they take account of social, ethical and environmental issues in investment. The change applied to about £800bn of assets, a third of the total managed in London.
- The Turnbull report on corporate governance required companies to establish systems to identify, evaluate and manage all risks, not just financial risks. The Turnbull report effectively put the risks arising from environmental issues onto the governance agenda in an explicit way.
- Companies are increasingly becoming the target of pressure groups. In particular, pressure groups are finding that investors are softer targets than the companies they have attacked in the past.

These three points are driving investors to look hard at ethical and environmental issues and how these issues should relate to their relationship with the companies they invest in. The consensus that is emerging is that investors want to deal with these issues by extending the corporate governance agenda.

The signs are that investor interest in sustainability will increase in the future:

I notice at Annual General Meetings of public companies that the question is getting more specific and if the detail is not given, it is asked for.

The evidence is more than anecdotal. A large group of investors has already met informally, as the Socially Responsible Investment Forum. At the beginning of 2001, the SRI Forum drafted guidelines that are in the process of being endorsed by the Association of British Insurers. The guidelines call for companies to demonstrate that they understand the risks and opportunities associated with social, ethical and environmental issues. Investors will be looking for companies to disclose the policies that they have in place for responding to those risks.

Even so, suspicions remain among UK corporations that the campaign for a stronger ethical and environmental approach is being driven by a minority of self-interested groups:

At our AGM, of the 15 or so questions we were asked, two or three were from shareholders who wanted to know about the accounts and the rest were from animal liberation supporters. AGMs are being hijacked by special interest groups, possibly to the detriment of shareholders with genuine performance questions to ask.

The reaction towards sustainability issues from analysts is rather different. A Business in the Environment survey found that only 9% of analysts see environmental issues as significant. The reason for this is most likely to be the fact that sustainability and social responsibility in practice are extremely difficult to measure. Clearly, brokers and fund management houses have a substantial training gap to address.

The business case for sustainability

Sustainability issues are important, but the challenge for companies is to wrap these issues in with delivering performance to shareholders. They have to get the balance right. But they must also find a way of communicating effectively with shareholders, analysts and the general public.

That is why corporate reputation is important, because many of us feel that we do work for companies that are doing good as well as delivering good returns for shareholders. But we're not getting that message across.

There are two main arguments against the widespread acceptance of sustainability as a modern business issue. The first, as we have seen, is a residual assumption that ethical and environmental issues are the domain of special interest groups. The second is that sustainability maybe incompatible with the main aim of any business – to produce profits although some business leaders have said that sustainability of the corporation is a major priority. The fundamental premise of any capitalist society is that a return will be realised on an investment. All but the smallest private companies must attract investors who are prepared to put money into the business in the expectation that they will get a return in due course. Of course, any company that chooses to ignore any stakeholder is foolhardy. But ultimately, it has to be shareholder value that prevails.

There are, however, strong business arguments in favour of sustainability:

- Companies need to distinguish themselves from the pack in an increasingly competitive world. This becomes more crucial during an economic downturn. Generally, as the economic environment worsens, companies show more interest in sustainability because they want to show that they have something special to offer.

- In order to develop a healthy, well-educated, well-fed customer and employee base, it is in the interest of companies based in the developed world to make some form of investment in the infrastructure of the developing world. North American and western European markets are nearing saturation. If growth is to be achieved, it will have to be found in the developing markets. In entering developing markets, companies face a specific problem; potential customers in developing markets are rarely concerned about the company or its products. If they are ill or hungry, they will not be thinking about spending what little they have on goods and services provided by western companies. If they are not educated, they will not be in a position to understand sophisticated products.
- The next generation of employees is much more interested in sustainability issues. There is a lot of evidence, much of it anecdotal, that young people, particularly graduates, consider it extremely important that the company they work for has strong values. Staff, too, like transparency. Corporate reporting will become more transparent because companies will not be able to hang on to their intellectual capital without it.

Most compelling of all is the reaction of the markets when an environmental or ethical crisis hits a corporation. Few companies can afford the poor publicity, or the downturn in share price, that follows an environmental disaster such as a large oil spill in an environmentally sensitive area. Markets and investors respond to a big environmental or ethical crisis. But on broader, less immediate issues, investors often wait for regulations before they make a judgement. For that reason, sustainability is still not a front line issue.

I'm clear what the business case is, but I'm not sure that it has generally been proven to or accepted by the vast number of companies out there.

Is sustainability really on the radar screen of most company boards? I doubt it.

What is needed is clear evidence that good corporate governance produces identifiable financial benefits.

The real problem is how you demonstrate that there is a link between sustainability and the creation of shareholder value. More could be done in relating good corporate governance to market multiples. It is possible to show that if a business is run well and governments encourage good governance, everybody gets three to four times richer.

A successful, sustainable public sector first requires a clean private sector. But cleaning up business and the government is extremely difficult to do partly because of a lack of transparency in banking. The sooner the City tackles this on its own terms, with the assistance of lawyers and accountants, the better it will be.

A universal issue

Sustainability, ethics and the environment are typically seen as a large company issue. This is partly because non-governmental organisations (NGOs) and other bodies intent on highlighting the issue do not have a lot of resources and so are aiming what they have at the large, high profile companies.

But it is not an issue purely for large, public companies. Shareholder value applies equally to private companies and this is particularly important in the current investment environment. A new breed of companies has emerged that are owned by private equity firms who have little or no real code of corporate governance.

It also applies to smaller organisations. Small businesses depend on their reputation just as large ones do. But for small and medium-sized enterprises (SMEs) in particular, the business case for adopting environmental standards is still to be made. They see it as an extra cost and wonder what value it is going to bring to the business. Why should they interrupt their profit search to do it?

There is a huge degree of cynicism among smaller company boards.

Even so, in the future investors will demand more and more evidence that companies, including SMEs, comply with socially responsible thinking. Many SMEs have great difficulty in attracting institutional investment to their business and part of the problem may be that they have not convinced the investors of their corporate governance practices.

Perhaps the most difficult question is how to find a method of enforcing sustainability that does not exclude the most marginalised – i.e. the small producers – from the system.

Enforcing sustainability issues

It is no longer enough for companies merely to assert that they subscribe to the principles of sustainability. They have to demonstrate it, in a world where generally, companies are not trusted by society to behave responsibly. Companies need to assure investors and the public at large on their commitment to, and stewardship of, the company's long-term social, environmental and economic sustainability.

We have moved from a 'trust me' world to a 'show me' world.

Recent years have seen some attempts to improve corporate governance and reporting. The effort, however, is not being led by the standard setting or regulatory bodies. The International Auditing Practices Committee of the International Federation of Accountants and the new International Accounting Standards Board have both put environmental reporting and other aspects of sustainability on the back burner while they deal with more basic issues. There is little pressure on either board to push the issue further up their agenda, mainly because sustainability is not generally seen as an issue for the standard-setting bodies:

Once you get outside environmental reporting, social accounting lacks the rigour that is needed to make it of universal interest.

There is a real temptation when discussing the enforcement of sustainability issues and corporate reputation to concentrate on the negative – the stick rather than the carrot. It is relatively easy to find a way of punishing companies that do not follow good corporate governance. It is less easy to find an incentive to encourage good practice.

A society that relies on crises and threats will never achieve its ultimate goal. A more constructive approach would be to start by looking at the business case for sustainability – the positives, rather than the negatives. How can companies improve their sales? Not by ducking boycotts but by finding a self-reinforcing relationship between their products and services and wider sustainability.

Sustainability is a value-driven set of policies and issues. Everything a company does must be consistent with the company's values.

It is not popular to say so, but if corporate reputation is to be established and maintained, a code of ethics must be signed by every member of a company and enforced by management. Unless there is pressure on the corporate sector to have clean governance, we will never get some of the more languid governments across the world to emulate that sort of behaviour.

A code of ethics is more likely to have a real impact on practices adopted by an organisation if it meets the following criteria:

- The code is relevant to the organisation and 'owned' and promoted by the board. Relevance in this context requires the inclusion of appropriate layers of detail in addition to high-level principles. The code should be seen as producing some positive benefits rather than just being a set of rules.
- The code should be understandable and communicated to all concerned, including major suppliers and customers. Supply chain contractors should be asked to adhere to the code.
- The code should be subject to monitoring and feedback to ensure compliance. Feedback should focus on what is important rather than on what is measurable.

- The code should be supported by a system that rewards good performance and provides change counselling in the event of bad performance. The organisation's infrastructure should encourage an ethical culture of best practice.

Sustainability must be embedded in the organisation. Ethics must be part of the culture, and that has a lot to do with training.

The missing link in many companies is training. Ethics must be part and parcel of the training of new recruits and the training of management. Ideally, there should be an ethical component to every training course.

Education has to start in the boardroom. But if sustainability education is to be effective on a large scale, it must then include the entire chain, from company employees to investment consultants, pension fund trustees, fund managers and analysts.

Sustainability at the governance level is abstract and difficult to communicate. It requires significant rethinking in the way a company is run if sustainability issues are to be integrated into performance appraisals or management structures. Ethics should be one of those things that line managers are required to look at not once in a blue moon but on a regular basis.

Ethics must be uncomplicated, very clear and easily explainable on the shop floor. If you can imbue at the lowest level of employment a real attitude about what's right and what's wrong, you will find it much easier to police.

The short answer of how to embed a socially responsible culture into a company is that it must face a major crisis. Only when it lives through a crisis can it explain whether or not all the codes, statements, recruiting measures, training and Board responsibilities actually mean anything. Companies will live with the inadequacies of their current systems until they hit a crisis point.

The role of chartered accountants

If companies or the professions do not take a lead in developing realistic and understandable measures for non-financial information, regulators may well force their own ideas on them in the name of public interest.

In the meantime, accountants can play an important role through their audit work. Information is easily manipulated and an auditor is ideally placed to check that companies' statements on ethics, the environment and sustainability are fair. That, in itself, may encourage better practice. A watched body behaves very differently.

There is a clear place for chartered accountants to take a lead in these areas. But it's not at all obvious that we will, or that we have a natural right to do it. We have to gain a position. We should not assume that the world is waiting for us. There are many other bodies that are looking to make a move if we do not.

The ICAEW can lead from the front, but if it is to do so, it must first detail its own social responsibilities and its approach to sustainable development. The ICAEW will take the first steps towards this in its 2001 annual report.