OXFORD BUSINESS ALUMNI

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Briefing 04.01

Relating to the capital markets: transparency and sustainability

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Thought leadership from the Institute…

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This briefing is based on a presentation by Graham Ward, President, ICAEW, at a seminar on 5 April 2001 jointly hosted by the ICAEW and Oxford Business Alumni

Globalisation is breaking down borders, both economic and political, through technology, trade liberalisation and deregulation. For companies, globalisation is bringing with it many opportunities and also many challenges, not least the need for transparency as well as accountability. Transparency is the number one key driver of confidence: confidence in the credibility of a country's public and private institutions, confidence in the integrity of its capital market, and confidence in its stability and sustainability.

It is a lack of transparency in the functioning of the multilateral trading system that has led much of civil society to feel left apart from the decision-making process. The knock-on effect, as riots at the World Trade talks, IMF and World Bank meetings and at Davos have shown, is that corporations are being viewed as the B52s of capitalism.

Some people believe they must be attacked as economically powerful and socially malign entities. Anti-globalists are convinced that, even if corporations do not have any malign intent, they have a negative impact and such fears, even when groundless, are often strongly held. It is difficult to shift the view that large corporations, particularly multinationals, are in it for the short-term money and care nothing for indigenous communities, nor for the environment.

So the pressures to demonstrate corporate responsibility have never been greater. While there are compelling reasons for corporations to assume social responsibility because that is 'the right thing to do', there are also, increasingly, sound economic reasons for doing so.

Social responsibility is part of a package of institutional and policy changes that reinforce the enormous good that economic globalisation is bringing worldwide. World business leaders have recognised that good corporate citizenship is now a necessary licence to operate their businesses and we are beginning to regard this not as a form of philanthropy, but as an essential component of corporate competitiveness and reputation. Now, more and more, these concepts are also being adopted by analysts and investors, very often as an integral part of their corporate governance investment criteria.

From the announcement on 16 March 2001 by Kim Howells, Minister for Corporate Social Responsibility, of the major initiatives he is instituting under the 'Business and Society' banner, and the European Commission's Social Agenda, to Kofi Annan's UN Global Compact, we are seeing corporate social responsibility being pushed to the very top of political imperatives.

There are two key points for businesses to bear in mind when relating to the capital markets:

- The first is that the confidence of the capital markets is only gained and maintained by a commitment to transparency at all levels of regulatory and corporate activity. Transparency lowers the cost of capital and creates innovative and liquid markets. It is the reason why the European Council of Ministers has just agreed at the Stockholm Summit in March to implement a regulatory overhaul across the entire European Union to create a single securities and financial services market.

- The second point is that the challenge of globalisation brings with it the need to mitigate against reputational risk. An impeccable corporate reputation is a prerequisite for maintaining investor confidence and hence, market value. It is the hardest thing to earn and the most easily lost. By committing to the concepts and principles of sustainability and corporate social responsibility in their broadest sense, companies will more easily be able to attract long-term patient capital and enhance the confidence of regulators and the wider public in their brands.

The cost of capital – opacity

The ultimate determinant of economic viability must lie in easy access to capital at fine rates and regulatory environments that are benign but at the same time robust enough to ensure confidence in the market. Business is bound by the environment in which it operates, it does not operate in isolation.

To say that the effects of governments' fiscal, prudential and regulatory decisions are critical to the health of business may be stating the obvious, but for many countries, that link has not always been clear: a point reinforced recently by a PricewaterhouseCoopers survey, called the Opacity Index.

The survey looked into the effects of corruption on the cost of capital; the legal frameworks in place that determine the flow of portfolio and foreign direct investment; fiscal and monetary policy which, if unpredictable, increase risk premiums on the cost of capital; regulation and enforcement within the capital market; and issues of disclosure, transparency and governance. These effects are explained in terms of both a hidden corporate tax and a risk premium when societies borrow through sovereign bond issuance.

Without doubt, the results were that greater opacity i.e. bad performance in any of the areas listed above, raises obstacles to the economic progress of countries and their citizens and, more specifically, raises the risk premium charged by investors. Greater transparency, or less opacity, on the other hand encourages investor confidence and keeps the costs of doing business under control.

The full details of the survey are available as a pdf file on www.opacityindex.com.

It is in all our interests to support global measures to achieve greater transparency and underpin that with regulatory frameworks within nation states that operate to globally accepted standards.

The Institute of Chartered Accountants in England & Wales and the rest of the UK accountancy profession, has been contributing to the International Accounting Standards Committee, the International Federation of Accountants, and the International Auditing Practices Committee since their inception to develop and promote the acceptability of a set of global standards in accounting, auditing and ethics.

And of course, on the governance side, the Institute was a driving force in preparing the Cadbury Report on the Financial Aspects of Corporate Governance in 1992. These principles have now become the globally accepted basis of many other codes of governance around the world.

Transparency

The principles of governance and, therefore, of transparency, have become international touchstones for engaging investor confidence. The financial crisis that began in mid 1997 in East Asia and rapidly spread to Russia, Brazil and other developing market economies was ascribed by the World Bank and others, not only to accounting and auditing irregularities but also, significantly, to lack of transparency and weak governance which held the whole financial system hostage. For market regulators, according to the OECD, corporate governance has become 'an issue of systemic stability in the financial markets providing early warning mechanisms that might be a limiting factor to herd behaviour in difficult market situations'.

What companies need is long-term patient capital. But these days, the global investor has plenty of markets to choose from. If companies are to attract and retain long-term patient capital from a large pool of investors, they need credible and recognisable corporate governance arrangements.

Companies and governments have to respond. And this means not only giving confidence to the international markets, but also strengthening domestic confidence.

Companies that subscribe to the principles of sustainability are letting investors know that the board itself truly believes in, and is planning for, the company's long-term prospects.

Sustainability

By the same token, the concept of corporate sustainability is attractive to investors because of its aim to increase long-term shareholder value. Adherence to principles of sustainability – that is the integration of economic, environmental and social growth opportunities into business strategies – provides criteria more applicable to today's 21st century environment than do mere historical financial figures. They hold resonance for the 21st century informed investor: corporate sustainability is an 'investable' concept.

On 27 March 2001, the UK Government produced a comprehensive, multilaterally-endorsed code of conduct for sustainability for multinational enterprises (MNEs) and announced that this was to be sent to business leaders and key Non-Governmental Organisations to raise awareness of the guidelines and encourage their use amongst UK inward and outward investors.

These guidelines establish principles covering a broad range of issues in business ethics including employment and industrial relations, environment, information disclosure, competition, financing, corruption, taxation and science and technology. And although the guidelines are not legally binding, OECD governments are committed to promoting their observance.

Corporate social responsibility

For companies, the publication of these guidelines at this particular time may well be no happy coincidence, as underlined by a recent survey of around 600 British MPs throughout all political parties. When asked what their views were on corporate social responsibility (or CSR), though 86% of them thought that CSR will have a positive impact on the UK economy, nearly all of them (91%) thought that businesses currently see it as window-dressing, little more than a public relations exercise. The business community clearly has a credible communications exercise to undertake.

The fact is that leading companies *are* beginning to implement coherent CSR strategies, based on sound ethics and core values which offer clear business benefits, including recruiting and retaining high calibre staff, controlling risks, identifying market opportunities, improving reputations and maintaining public support. These are important strategic decisions.

But while business is leading the way in best practice, it is not the role of companies to undertake the work of government as society's social conscience nor should government use legislation to force companies into adopting some standardised form of CSR. Government must play a key role in encouraging best practice by creating the right kind of regulatory environment and incentives to allow companies to develop the CSR policies and practices that best suit them.

The Government's Company Law Review is in support of a mandatory Operating and Financial Review which will include disclosure of how companies manage their 'wider relationships' and their social and environmental impact. By ensuring that CSR is a part of statutory disclosure, you ensure that it becomes a critical part of board considerations at the same time as allowing flexibility in its application.

As companies commit more resource to their CSR and sustainability policies, one warning should ring out in their boardrooms: that this progressive internal stance on sustainability must be aligned with other activities such as lobbying positions and external memberships. It is no good publicly paying lip service to the principles of sustainability, or governance or any other area, if you are then going to lobby privately against regulations or robust frameworks that will ensure these principles have a sound footing for consistent implementation.

Companies who do this expose themselves to reputational risk. A risk that becomes even greater for a multi-national if it has different stances and levels of commitment throughout its subsidiaries, dependent on how convenient it is for them given their operating environment. Not only that, but reputational risk can also lie very much in external affiliations; as many major conglomerates found out to their cost when they were affiliated with the Global Climate Coalition which argued aggressively against action to reduce greenhouse gas emissions.

Change being forced by investors

And economic pressure for companies to take seriously issues of governance, sustainability and corporate social responsibility, has been coming directly from another source: investors themselves.

Major institutional investors have brought shareholder activism to the fore. Amongst the most powerful of these are Hermes, the UK's largest pension fund, and CalPERS, the California Public Employment Retirement System which is the largest public fund in the US, whose global corporate governance strategic alliance states that all their shareholdings are managed with governance criteria as an integral part of their polices. No board is going to ignore the demands of such powerful investors.

In July 2000, the Government's Socially Responsible Investment regulation brought UK pension funds to the forefront of socially responsible investing in the European Union and pioneered the use of financial institutions as a key policy instrument to bring about sustainable development. The new regulation requires pension fund trustees to disclose their policies on socially responsible investment. Subsequently, a UK Social Investment Forum survey at the end of 2000 found that of the 171 funds who responded, which represented more than £300 billion in total assets, 59% incorporated socially responsible investment into their investment strategies. The message for companies is that doing well and doing no harm is obviously no longer good enough.

Whilst some funds have merely excluded investment in specific activities or industries and others taken a more pro-active stance through investment in environmentally sound, socially progressive businesses, now a third way has evolved. This involves the fund manager undertaking to influence corporate behaviour by encouraging companies in his or her portfolio to adopt best practice on social and environmental issues.

Although few funds currently take the 'third way' it may well become more of a mainstream stance as the investment community itself comes under greater public scrutiny.

Reporting and measurement

The difficulty of course, for all of us, is that it is all very well to subscribe to principles and even to put them into practice, but unless you can convince investors that they have value, the chances are, that eventually, they will lose confidence in your judgement.

For the capital markets as a whole, indices enabling comparative performance across markets do exist. Joining the well-known Dow Jones Sustainability Group Index, the newest is the Global Sustainability Index, released at Davos in January this year, which attempts to measure countries' environmental sustainability, just as gross domestic product is used to measure economic growth. Based on the Environmental Sustainability Index of 22 key factors that contribute to environmental performance, we heard at Davos that Finland, Norway and Canada came top with Britain coming a poor sixteenth after Uruguay.

Reporting on sustainability and corporate social responsibility are relatively in their infancy but various groups around the world are making common standards in this area their aim. Not least amongst them, may I modestly say, is this Institute. We are currently looking at the financial and non-financial reporting issues and clear standards of measurement and attestation through our Sustainability Group. This group comprises senior members from business, practice and academe together with government observers and is supported by an advisory group, chaired by myself, of business leaders, investors, practitioners, personnel managers and the President of Transparency International UK.

We have also contributed to the work of The Global Reporting Initiative, whose Sustainability Reporting Guidelines we saw published in June 2000 in an international, multi-stakeholder effort to create a common framework for voluntary sustainability reporting.

For the corporate sector, the real value of this type of reporting lies in the answer to the question: is it meaningful? Will investors perceive it to have value?

Though research has shown that investors want corporate information on a company's strategy implementation, management's trustworthiness, strategy quality, innovation ability, the quality of the human resources, or environmental and social activity, the measurement and attestation of this information is in its infancy.

It is currently in the hands of companies, such as Shell or BP, who are experimenting and devising best-practice, or in the hands of the professions, in particular the accountancy profession, who are grappling with the complexities of finding an understandable and measurable framework for this non-financial data.

Whatever the methodologies, the independent verification of, and assurance on, this information is, and will continue to be, a critical part of giving confidence to investors (in the same way that you have confidence in the audited accounts). Without this, you introduce that element of risk premium and a higher cost of capital.

Companies have also been experimenting with intellectual capital accounting for a number of years. Encompassing human capital, structural capital and customer capital (including brands), intellectual capital accounts have taken various forms the most well-known of which must, I believe, be Skandia's 'Navigator'. Human capital is a part of the value reporting chain that is a key element of the investor's 'wish list' of disclosures and it is now accepted wisdom that companies that ignore human capital will go the way of the dinosaurs.

Our challenge in the immediate future will be to ensure that the global XBRL project (or extensible business reporting language) which will revolutionise corporate reporting on the internet by providing a common computer language for all financial data, will also be translated into the area of non-financial data.

Conclusion

Companies should view their commitment to sustainability, whether economic, social or environmental, as enlightened self–interest. Business, in the shape of corporations of all sizes, is what makes the world go round. Stable economies, educated work forces and vibrant markets need long-term investment and it is the job of business to ensure that it plays its part in attracting long-term, sustainable capital.

It is no longer enough for companies merely to subscribe to general principles. From the intense interest that governments and other public institutions are taking in corporate activities, to the economic pressures in the search for capital at fine rates and the demands of investors globally, companies must now demonstrate that they fully participate in the drive towards ever greater transparency.

Internationally recognised principles of governance and transparency, sustainability and corporate social responsibility are now very real drivers of corporate success.

Not only do companies have a duty to their shareholders to maximise financial value, they have a duty to their environment and to the society in which they operate which will maximise that value. Shareholder value creation and social responsibility are not mutually exclusive, they are mutually dependent.

And this dependence is being translated through to the value of corporate reputation. Corporations whose strategies are holistic – a balance of their fiduciary duty to shareholders with their social responsibilities across the board – are finding that it enhances their reputation and has a direct and positive link to their market value. Transparency is good for investors, good for companies and good for the capital markets.

The Centre for Business Performance sponsors and promotes leading-edge research on performance-related issues of immediate and long-term importance to the business community. Its goal is to advance thinking and practice related to performance enhancement and value creation and to encourage discussion of new ideas by directors, entrepreneurs and others.

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