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**Corporate Social Responsibility from the Private Investor Viewpoint**

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*Janet Sidaway has worked in the engineering industry throughout her career, in the public and private sectors. Her first job was as industrial engineer for Tube Investments (later the TI Group); then she was responsible for two sector committees at the National Economic Development Office, on foundries and process plant. She moved to the financial sector in 1984 and was an engineering investment analyst for fifteen years. She was twice voted one of six 'star analysts' in the Extel surveys and was voted top engineering analyst six times in the annual survey of Finance Directors. In 1999 she left the City to return to university part-time and in 2002 set up CSR Consulting Ltd. with Steve Askins.*

I have been asked to talk about Corporate Social Responsibility from the Investor Viewpoint. I would like to give it a subtitle: "From *nice to have* to *must have*" because there has been a remarkable transformation in attitudes to CSR in the last eight years.

My talk has three parts:

1. A discussion of CSR definitions;
2. A look at the influences which have shaped it;
3. What to look for as an investor.

**1. CSR Defined.**

The first issue is to define corporate social responsibility. I shall use its acronym, CSR, throughout the talk as it remains the best understood umbrella term for a concept which is nowadays variously called corporate citizenship, corporate responsibility, or sustainability: all terms which you might see on company websites.

At its most basic, CSR describes non-financial issues which affect or are affected by a company's activities: its policies and practices (unfortunately often **not** the same thing) towards its employees, its suppliers, the community within which it operates, and its impact on the environment. You might also see it described by the acronym SEE (social, environmental, ethical) or one which is increasingly replacing it, ESG (environmental, social and governance).

When I worked as an engineering and electricals analyst for Dresdner Kleinwort Benson, the idea of CSR as a separate category was unknown. But it would be misleading to say that the concepts CSR embodies were ignored. As an analyst, I realised that the best performing engineering companies were those which had what is now thought of as a holistic approach to all aspects of running a business; their employees were motivated by supportive personnel policies, they established long-term relationships with key suppliers, they consulted local communities where relevant on operational issues. This was just part of running a company well.

However the world is more complicated now. The advent of the internet means companies can quickly be found out if they are mismanaging such issues. Aggrieved employees, exploited suppliers, poorly treated communities in developing countries, or concerned environmentalists, can quickly publicise their grievances, aided and abetted by NGOs whose very existence often depends on campaigning against such practices: indeed, if it does not sound too cynical, often exploiting them for their own organisational purposes.

Not only are companies which mishandle such issues likely to be less profitable in the long term, but they can easily lose that most precious resource of all, reputation. As Iago in *Othello* says:

*Who steals my purse steals trash ... but he that filches from me my good name  
Robs me of that which not enriches him, and makes me poor indeed.*<sup>1</sup>

CSR is about protecting that good name. It is not only about managing a business in a way to reduce the risk of catastrophe, but to know how to deal with the unexpected disasters in a way that protects the company's reputation.

A final point on definitions.

CSR is often confused with SRI, socially responsible investing. The latter is based on criteria for investment, not on management policies applicable to any corporate entity. Obviously there is some overlap as no SRI fund manager would want to invest in a company with a poor CSR record. But SRI funds are set up with strict investment criteria (eg no tobacco, no armaments) whereas CSR reporting in some form is now a legal requirement for all quoted companies, as I will describe in the next section.

Nonetheless, I believe it was partly the success of SRI in its early days, and the publicity that enterprising fund managers like Jupiter generated, that started to publicise the benefits of formal CSR reporting.

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<sup>1</sup> *Othello* Act 3, Scene 3.

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## **2. The influences which shaped CSR**

How did we get here so quickly? The impetus has come from three converging strands: social (in terms of society's changing priorities), investor perspectives, and finally legal developments.

### *Social Pressures*

I won't dwell on the social pressures as UKSA's focus is obviously on investment. But they are important. Would society have urged greater accountability if there had not been an Exxon Valdez, or a Bhopal? It was incidents such as these which gave the impetus to Friends of the Earth and Greenpeace to become more closely involved in corporate naming and shaming.

These pressures evolve and should not be ignored, not only because they are legitimate in themselves, but because there is a media bandwagon effect. One example is pressure on companies to report on their carbon footprint. Although this pressure originated in genuine concern for the environment, the role of the media in 2007/8 which incessantly highlighted the dangers of climate change contributed to almost hysterical and uninformed demands on companies. As so often happens, because of the subsequent publicity over distorted evidence and selective reporting, the pendulum has probably swung too far the other way in the court of public opinion; but the legacy of increased regulatory demands on company reporting remains, as I will outline later.

### *Investor Perspectives*

It was because of such social pressures and the reputational issues they could expose which made major institutional investors start to worry. They realised that they had no way of knowing what an individual company was actually doing about these non-financial issues, despite their potential for serious financial and reputational damage.

There had already been some attempts to persuade companies to increase their transparency. The first was the suggestion of triple bottom line accounting in 1981, in the US. This involved expanding the traditional reporting framework to take environmental and social performance into account in addition to financial performance. The initial focus was however on Social Enterprises, not publicly quoted companies. It was then extended to investment and lives on in TBLI, an organisation founded by Robert Rubenstein, now based in Amsterdam.

In the UK as well, non-financial issues were being considered by investors, but primarily in the retail sector, led by firms such as Friends Provident. At this stage such reporting was therefore still in the realm of *nice to have*. However, CSR reporting started to move into the mainstream institutional investor perspective with the Pensions Act of 1995.

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This required pension trustees to prepare a written statement of the principles governing their investment decisions. Then in 1999 the Occupational Pension Schemes Amendment Regulations introduced the requirement for the statement to include a statement of the policy on:

- a. "The extent to which SEE considerations are taken into account on the selection, retention and realisation of investments", and
- b. Voting policy.

There were, and still are many on-going issues of fiduciary duty associated with such mandates for the trustees' pension fund managers, i.e the extent to which total return should or should not be an overriding principle, but it did mean that in theory trustees were expected to pay more attention to non-financial issues, so that – again in theory – trustees and pension fund managers should require more reporting of these issues in the companies in which they invested.

By 2002 the game was changing. Major investors recognised that badly managed environmental and social issues could impact on a company's profitability and were therefore a risk. As such, they started to understand that the proper management of CSR should be an essential element of corporate governance, and therefore should be monitored and audited as part of the risk management required by the Turnbull Report. CSR was therefore more than *nice to have*, it was becoming a Board level concern. Reflecting this development, the ABI (Association of British Insurers) whose members own about 13% of the UK equity market, issued "Disclosure guidelines" urging UK listed companies to report on what the ABI then called material SEE issues in their Annual Reports.

As the ABI's prime interest was business risk, they urged that the Board took responsibility for such issues and ensured they were managed and monitored effectively. These disclosure guidelines remain substantially the same today, although SEE is now called ESG, but more weight is now put on directors' incentives and bonuses to include ESG. The ABI has been increasing pressure on companies to comply with the guidelines, and the ABI secretariat contacts any company which it thinks fails to disclose its policies adequately. Ultimately this could become a voting issue.

The ABI's guidelines were then followed by a statement from the broader based Institutional Shareholders Committee, comprising the Association of Investment Companies (AIC), Investment Management Association (IMA), and the National Association of Pension Funds (NAPF) as well as the ABI. This made it explicit that the larger institutional investors individually or collectively would engage in dialogue with any company which seemed not to be reporting on and managing areas of material significance to its on-going financial performance. The investors themselves are now highlighting this as well. If you look on the website of any of these major investors like Hermes, BlackRock, Legal and General, and Standard Life you will find statements like Fidelity's:

*"FIL believes that high standards of corporate responsibility will generally make good business sense and have the potential to protect and enhance investment returns. Consequently, our investment process takes environmental, social and governance ("ESG") issues into account when, in our view, these have a material impact on either investment risk or return."*

### *Legal changes*

Both the changing expectations of society, and investors' recognition of the risks to any company of ignoring them, have had a remarkable effect on legal obligations for companies, both in company law and the new Combined Code. These unquestionably move CSR reporting from *nice to have* to legally *must have*.

### Companies Act 2006

The Companies Act 2006 became mandatory for Annual Reports relating to financial years beginning on or after 1 October 2007. It had taken four years to draft, debate, and redraft. At an early stage it contained the requirement for companies to provide an Operating and Financial Review (OFR); this was repealed by Gordon Brown in November 2005 but then replaced by the so-called Enhanced Business Review (EBR), because of an outcry by many NGOs, but particularly Friends of the Earth. The revised requirements are summarised in Section 417.

Importantly for CSR reporting, it meant that the business review in the directors' report had to be extended significantly, to include information on environmental, employment, social and community issues and the main factors likely to affect the company's future business.

The key paragraphs of Section 417 for CSR reporting state that:

"1. Where a company does not provide information on environment, employment, social and community issues "it must state which of those kinds of information it does not contain".

i.e. directors must be aware that comment on these non-financial issues **is** necessary even if only to explain why they are not reporting on them. They should therefore ensure these issues are included in the company's internal review process.

Even more significantly, the EBR requires relevant key performance indicators:

"2. The review must, to the extent necessary for an understanding of the development, performance or position of the company's business, include —

(a) Analysis using financial key performance indicators, and

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(b) Where appropriate, analysis using other key performance indicators, including information relating to environmental matters and employee matters".

*(my emphasis)*

KPIs are a key tool for investors in assessing a company's CSR effectiveness, and are discussed below.

### Corporate Governance Code

However, there is a second piece of relevant legislation; the new Combined Code, now renamed the Corporate Governance Code, which was published in May 2010 and applies to financial years beginning on or after 29 June 2010. Listed companies are required to report on how they have applied the main principles of the Code, and either to confirm that they have complied with the Code's provisions or – where they have not – to provide an explanation: i.e. the controversial "comply or explain." The main difference with the 2008 Combined Code concerns the responsibilities of the Chairman and the non-executive directors: the Chairman must take responsibility for leading the Board, and the non-executives for challenging and developing strategy.

You might ask what this has to do with CSR. In fact these legal developments are central as they ensure that CSR is recognised as integral to corporate governance.

No longer can a Chairman and the Board members fudge their responsibilities for non-financial issues. They must be aware of their significance, and if material must measure and manage them. Either way they must report on them.

A third quasi-legal element linked to these, the Stewardship Code, also published last year, has been introduced to encourage institutional investors to report on their monitoring of investee companies' non-financial reporting. This was issued by the FRC, in response to a recommendation by Sir David Walker following his review of corporate governance in the financial sector, and complements the Corporate Governance Code. Its purpose is to encourage investors to seek on-going dialogue with the companies in which they invest, and report on the results. As with the Corporate Governance Code, the emphasis is on "comply or explain." During 2011 the FRC will be monitoring progress and issue a formal review of the Code's effectiveness.

### Carbon Footprint Reporting

In parallel with the pressure on Boards to integrate CSR issues into their whole management process, there have been further legal developments relating to carbon emissions.

The Carbon Reduction Commitment Energy Efficiency Scheme (CRC) is a mandatory carbon emissions reporting and pricing scheme which came into force in April 2010 and aims to reduce significantly UK carbon emissions not covered by other pieces of legislation. Its primary focus is emissions in non-energy intensive sectors in the UK, and complements the role of Climate Change Agreements and the EU Emissions Trading Scheme, which are directed primarily at energy-intensive organisations. The first annual report of emissions is due in July 2011. Companies which have taken environmental issues seriously and been early movers in carbon measurement have had a head start. Others might be struggling.

Another carbon related acronym with which you might be familiar is the CDP, or Carbon Disclosure Project. This was launched in 2000 "to accelerate solutions to climate change by putting relevant information at the heart of business, policy and investment decisions." There is increasing pressure on UK listed companies by their investors to participate in this as those which decline are perceived to have increased reputational risk. Some investors have said that participation in the CDP would soon become an investment criterion; and the NGOs and green lobbyists are urging that participation should become legally mandatory.

### **3. CSR in practice for the private investor**

My involvement in the world of investment has been only for institutional investors, but it seems to me that improved CSR transparency could be as useful if not more so to the private investor who wants to avoid a company which is likely to be affected by risks which might adversely its share price.

I suggest that the focus should always be the Annual Report. This is the only legal document of record and as such is monitored by the FRC and ABI. Within the AR, there are four main areas to check when assessing a company's CSR performance: Key Performance Indicators; the Enhanced Business Review; the CSR Report itself; and whether or not there is a whistleblowing policy. It might also be helpful to see if a company has a code of ethics (however called) but the value depends on who has agreed its wording and how widely it is communicated; not always clear from the AR.

#### *KPIs*

I referred earlier to the Companies Act requirement to provide "key performance indicators". These are defined as "factors by reference to which the development, performance or position of the company's business can be measured effectively." The emphasis should however be on *materiality*, so will differ from company to company.

Examples would be

- Environmental: statistics in greenhouse gas emissions, water usage, amount of waste recycled.
- Employment: health and safety record, absenteeism, training provided.

Too often these are woolly and aspirational. The most useful information, based on the Drucker principle that you cannot manage what you do not measure, is how these are being managed, and the trend, not the absolute numbers. Where realistic there should also be medium term targets to set against subsequent year's results, and discussion of how the company has performed against the previous year's targets.

The most significant non-financial KPIs should be included with the financial ones, preferably at the front of the Annual Report.

*The Enhanced Business Review*

This should show that CSR is not just PR "greenwash" but how the directors are managing and monitoring non-financial issues.

*The CSR Section*

The CSR section itself should give more detailed information focusing on items which are material, backed by further KPIs on performance. Some institutional investors would like these to be on a divisional basis, but for most companies this is regarded as giving too much information to competitors.

*Third Party Whistleblowing Process*

Many organisations inadvertently, create a culture of fear where employees do not like to admit their own failures, or to point out short-cuts or actual wrongdoing by others. Investors should therefore check that there is some form of independently-run confidential "helpline" to encourage reporting on such issues, and also that there is a process of Board level review on the calls the helpline is receiving. This process should be clear in the Annual Report.

**Conclusion**

I hope I have indicated the extent to which CSR has moved from a fringe interest to a mainstream element of corporate governance, and hence long term profitability. Measuring and managing non-financial areas of any business is the only way that the overall financial performance will keep improving.

That, surely, is what corporate social responsibility is really about: underwriting the sustainability of your investment.

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