

# Taking up the CSR challenge

Janet Sidaway charts the rising importance of ethics in the business community, but suggests that it needs to be an even more central tenet for investors



**W**hen I did an MBA in the 1970s, “Ethics is east of London; that’s all you need to know” was considered sufficient. Much has changed since the relevance of corporate ethics was so summarily dismissed. Business ethics are now seen as the foundation of a company’s corporate social responsibility (previously known as its social, environmental and ethical policies, and increasingly referred to simply as corporate responsibility).

Some business schools, such as Nottingham, have even set up separate departments of corporate social responsibility (CSR); many larger companies have separate corporate responsibility departments; and many more have demonstrated their commitment to it by publishing codes of conduct.

## Legislative framework

On the investment side, the issues highlighted by socially responsible investment (SRI) are no longer regarded as peripheral. Most major institutional investors now include either a direct reference to social and

environmental responsibility in the corporate governance guidelines they issue to companies, or express their support for the ABI guidelines on it, published in October 2001.

On the corporate front, the legislative framework for making CSR reporting mandatory is also intensifying. The proposed Operational and Financial Review, likely to be law by 2005, will enshrine social and environmental reporting principles, although the precise content will not be clear until the government has published its draft regulations and they have been consulted upon and finalised. As a risk issue, identifying potential CSR risks was implicit in the Turnbull recommendations even though many companies seemed not to recognise this; now these recommendations are part of the new Combined Code, such risks should be more fully detailed.

Initially, it seems that CSR responsibility has arrived. However, this optimistic view is misleading. Beneath the surface, some important issues have not yet been addressed in the investment

community, and these affect the way companies, particularly in the mid-cap sector, address and communicate CSR issues.

One major factor that makes companies cynical about the institutional investors’ genuine commitment to CSR is the perceived lack of common interest between the institutions’ corporate governance departments, and the fund managers whom they meet on a regular basis. Corporate governance guidelines might include statements on the importance of CSR; occasionally the corporate governance team might contact the company secretary about an issue of concern, on the assumption that this would then be passed on to the chairman.

## Lack of interest

But rarely, if ever, does it seem that these concerns are expressed in meetings between fund managers and the chief executive and finance director, and questions on CSR policies and progress do not feature on the regular agenda in the same way as financial and management issues.

The second major factor is the total lack of interest in CSR in the sell-side community. When an analyst receives a CSR report, the most common reaction seems to be to throw it in the bin, with no thought even to recycling. When asked why, the response is that CSR is not relevant to their assessment of the company, and that as analysts they are never asked about CSR issues by their mainstream

institutional clients, so do not need to know about this. So, as with buy-side discussions, senior executives are not challenged on CSR.

This failure to pay any attention to CSR by the mainstream fund managers and sell-side analysts shows not only that they do not recognise the role CSR can play in creating or destroying shareholder value, but that they do not even listen to their own corporate governance colleagues. Yet the financial importance of CSR has been cogently argued by many corporate governance experts, and well summarised by Alistair Ross-Goobey: “Corporate governance is only about reducing the cost of capital. It is not a moral crusade.” (*FT*, July 7th 2003).

If mishandled, CSR can destroy shareholder value as it is a source of potential risk, financial, reputational or both. In the long run damage to reputation can prove the most costly. The financial implications of environmental and health and safety risks have long been identified, so physical risk assessment procedures tend to be well established in these areas. But it was only the reputational damage done to Shell from the Brent Spar episode that forced it into rethinking its whole CSR strategy.

Consumer boycotts of Nike following allegations of human rights violations in its Vietnamese suppliers has led to a radical change in its sourcing policy, but at what cost to its reputation? Employee issues such as discrimination, community



issues such as hostility over decisions such as plant closures, involvement in perceived corrupt regimes, or allegations of direct corruption, can all seriously damage a company's reputation, particularly if the issue is publicised by a local or national NGO. Boeing is a topical example; breach of its own ethical policy led to the firing of the finance officer and various others and to the resignation of the chief executive.

More serious for the firm's long-term prosperity, the Pentagon has put on hold an \$18 billion contract for refuelling tankers until an investigation into possible ethical misconduct is completed. If Boeing fails to win it, at least 500 people will be made redundant.

### **Outperformance**

However, a positive response to CSR can enhance shareholder value. A recent study by the Institute of Business Ethics, *Does Business Ethics Pay* (April

2003) did suggest that “there is strong evidence to indicate that larger UK companies with codes of ethics... outperform in financial and other indicators those who say they do not have a code.” The sample was, however, small. Rather than rely on academic studies, I think common sense would suggest that most employees prefer to work for a firm that is perceived to act responsibly both to its own employees and within the wider community. This was certainly the message from the engineering industry at a conference organised by the Royal Academy of Engineering in September, “Ethics and Engineering: doing the right things and doing things right”.

Here BOC, the Arup Group and Rolls Royce gave specific case studies showing the benefits to the company itself of engagement, transparency, and continuing, sustained dialogue in dealing with all a

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company's stakeholders.

CSR is at least becoming more widely acknowledged by the corporate community. Pressure from such investors as Hermes, BGI, Morley, and ISIS and collectively by the ABI and NAPF, has meant that - at least according to their annual reports - many companies include CSR on the board's schedule of matters, and discuss it regularly.

To what extent is this a PR exercise, and to what extent is it actually embedded in the companies?

Because most questions on a company's CSR policies and progress come from specialist SRI funds, third party agencies like EIRIS or PIRC, or NGOs, larger companies tend to delegate them to a member of their CSR department. Smaller companies, with fewer resources, delegate to the company secretary or to the environmental, health and safety manager.

The ABI monitoring service suggests that although there has been an improvement from the previous year [2002], in 2003 to date, only 2% of the FTSE 250 companies' annual reports have "full disclosure" - ie, giving full details of management procedures and the linkage to the business of their CSR risk management process. Until senior executives in both large and mid-cap companies realise that the company's owners are as serious about CSR as about other key aspects of their performance, there is a danger that the executives will not regard CSR as an integral part of the

management function for which they are directly accountable, and will not report on it adequately.

A third reason for company cynicism on investor pressure on CSR is the publicity surrounding the investment community's own ethical behaviour on such issues as conflicts of interest, mis-selling, hidden charges, and the lack of transparency caused by soft commissions.

### **Profitability suffers**

The fact that there has been such a long gap between the publication of the FSA's discussion paper, "An ethical framework for financial services" issued in October 2002, and any summary of the conclusions (still awaited) suggests a lack of urgency. This does not mean that the profession is not ethical. Members of the AIMR of course have their own code of ethics, which lays down high level principles and five specific standards of professional conduct covering relationships with the profession, employers, clients and prospects, and the investing public.

Ian Thomas's article in *Professional Investor* (November 2003) illustrated that "ethical challenges live with us every day". His conclusion that "our ethics provide the platform that supports our reputations" shows the other side of the CSR coin. If any member of the investment community is seen to be acting unethically, not only its reputation but its actual profitability will suffer: Unilever has just fired Putnam Investments, accused of fraud in the US mutual

fund scandal, from managing part of its UK pension fund.

It is therefore in the interests of investment professionals not only to act ethically themselves, but to ensure as far as practicable that the companies in which they invest or advise others to invest in are doing the same. "An integrated, well-managed corporate social responsibility policy has positive operational benefits, and the reputational and financial risks of ignoring CSR can be huge."

Senior executives will only be convinced that their shareholders take CSR as seriously as other aspects of company performance when they are regularly challenged on CSR by both buy-side and sell-side analysts; and sell-side analysts will only take CSR seriously when they recognise that their company analysis is flawed if they fail to take CSR into account.

Investment professionals therefore have an important role to play in ensuring that CSR is properly integrated into the corporate management processes. ■

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### **On file...**

#### **AIMR Body of Knowledge III**

*Professional Investor*

#### ■ **November 2002**

Environment: What price world summits  
*Hilary Stone*

#### ■ **July/August 2001**

Environment: Waste away (environmental legislation)  
*Hilary Stone*

#### ■ **February 2001**

Environment: Cost of new regulations  
*Hilary Stone*