



# What should companies be responsible for?

WHAT WE THINK: A DIALOGUE IN CORPORATE GOVERNANCE

NEW CHALLENGES INITIATIVE

The ICAEW thought leadership initiative *Dialogue in Corporate Governance: New challenges* is considering five questions arising from recent events and seeing how they affect the foundations of existing corporate governance frameworks. We intend to explore these questions in a series of bite-size thought leadership projects.

While accepting that there are no easy solutions, we hope to bring greater clarity to people's thinking through dialogue with a range of interested parties and stakeholders including boards, investors, and academics.

#### Five questions

1. **What should companies be responsible for?**
2. What are the overarching principles of corporate governance?
3. When is comply or explain the right approach?
4. How diverse should boards be?
5. Who should be covered by codes?

A number of major changes have taken place in capital markets over recent years. These include: the growing importance of non-equity financial instruments; new types of equity owners; changes in the services offered by, and the use of, intermediaries; and pressures to harmonise internationally diverse practices in corporate governance.

Furthermore, a number of major business controversies are discussed as corporate governance issues, for example: state bail-outs of failing financial institutions during the economic crisis, public outcry over executive remuneration, and the lack of diversity on boards.

These changes and controversies present significant challenges to existing models of corporate governance built around the agency theory which sees boards of listed companies acting as agents of absent equity owners. Moreover, the changing nature of capital markets tests the validity of existing models of corporate governance.

Rather than treat current controversies as topical and fleeting matters, we intend to explore them as symptoms of misalignment between today's markets and corporate governance frameworks. We invite anyone interested in corporate governance to join our dialogue at Talk Accountancy [www.ion.icaew.com/Talkaccountancyblog/26707](http://www.ion.icaew.com/Talkaccountancyblog/26707) or email [corporategovernance@icaew.com](mailto:corporategovernance@icaew.com)

# What should companies be responsible for?

## Discussion of question 1

This paper considers what companies should be responsible for in the light of challenges that have emerged in the wake of the global financial crisis. Our discussion will help assess the implications of those challenges for corporate governance. Although universal in application, the examples we discuss are mostly drawn from UK experience.

The primary focus of this paper is the responsibilities of companies rather than the mutual responsibilities between companies, boards and shareholders that are defined for example in the UK Companies Act 2006 and the UK Corporate Governance and Stewardship Codes. The range of companies considered here is broader than is usual in corporate governance discussions which focus on publicly listed companies.

## FUNDAMENTAL RESPONSIBILITIES

We identify four responsibilities that are fundamental to companies today.

### 1. Achieving a business purpose

A company needs to achieve a business purpose which stakeholders can understand. It may be, in the case of a retail bank, to offer financial services suitable for its customers or, in the case of an energy company, to supply energy on a reliable and sustainable basis. Stakeholders including employees, customers, suppliers and lenders, as well as shareholders, all expect companies to achieve their business purpose. Serving its purpose effectively generally enables a company to generate continuing profits and value for shareholders. However, generating profits and shareholder value is not in itself a sufficient business purpose for a company.

The business purpose of a company needs to be clear internally and externally. The identity of a company becomes confusing where its business purpose is inconsistent, ambiguous or in conflict with other aspects of its corporate identity. It can for example be a challenge for conglomerates that may struggle to communicate what they are for or about. At the same time, a business should not be so focused on a specific purpose that it ignores changes in its environment. Therefore, innovation and adaptability are essential for a business purpose to be viable.

### 2. Behaving in a socially acceptable way

Social norms set boundaries for what is acceptable as business culture and behaviour within societies where a company operates. While social norms may be generally well understood, they can sometimes be poorly articulated, volatile and even appear extreme

or biased. Companies may need to identify what is socially acceptable through public engagement and monitor expressions of popular opinion and trends surfaced in traditional and social media.

Media and public focus on certain topics or aspects of corporate behaviour may last only for brief periods of time, but companies will need to determine when to rise above short-lived social expectations and to take actions in the light of continually evolving social norms.

Companies also need to recognise that different communities (eg, the financial services sector or their particular business) develop their own norms, and these community level norms may be radically different from those prevalent in wider society in ways which suddenly become apparent when those communities are subject to external scrutiny.

### 3. Meeting legal and regulatory requirements

Legal and regulatory requirements are made up of general external requirements (eg, relating to employment, health and safety, anti-corruption and taxation) and private contractual and fiduciary obligations (eg, relating to company pensions and debt covenants).

Being based on law, these requirements are mostly public and understood by those to whom they are applicable. Breaches of these requirements may lead to formal sanctions such as prosecution, disciplinary actions, penalties, suspension of rights to trade and litigation as well as reputational damage.

### 4. Stating how responsibilities are met

Companies are expected to acknowledge their responsibilities, provide information on how effectively they meet them and be answerable for their actions. A company may accept its responsibilities and act accordingly, but being accountable is a separate responsibility: it is about acknowledging those responsibilities publicly, reporting on how they are discharged, and being answerable for consequences. Companies need to be sensitive to expectations of those to whom they owe that accountability as their relationships are often long term.

These four responsibilities are of fundamental importance for companies to operate successfully in today's business environment, although satisfying them may be very difficult. We also accept that they can be challenged, be in conflict with each other, and undergo substantial changes of content. Their relative importance and relevance will also be perceived differently from company to company and over time.

## **BENEFITS OF PROPOSED APPROACH TO RESPONSIBILITIES**

We believe that there are important benefits from recognising that companies have a full and diverse range of responsibilities.

Being sensitive to the full range of its responsibilities can help a company to be agile and adaptable to its environment and identify new opportunities on a sustainable basis. If companies are conscious of these responsibilities and consider what they can do to meet them, they should be better at developing coherent responses and anticipating or even eliminating potential expectation gaps in a changing business environment, for example as social norms change.

The need to rebuild public trust in business is attracting widespread attention as a result of the global financial crisis. Acknowledging a broad range of responsibilities and continually trying to meet them will give companies a solid foundation for building and maintaining trust.

Moreover, where companies are convinced of the importance of the full range of their responsibilities and attempt to meet them, legislators and regulators can focus on developing requirements that are proportionate to specific needs. This should help companies and other stakeholders resist the pressure for the inefficient or ineffective use of hard law and regulation to address social norms that are hard to articulate and constantly changing or business purposes that are unique to each company. Principle-based approaches such as codes and guidance are often more appropriate in relation to these responsibilities, but only if companies are seen as committed to act. The lack of such commitment will lead to calls for prescriptive hard law and regulation which is costly to implement, ignores the diversity of companies and their circumstances, and discourages companies' own adaptability.

## **EVIDENCE SUPPORTING THE PROPOSED APPROACH**

The following examples illustrate how challenges to the corporate behaviour and culture that have emerged in recent years could be better addressed by companies that acknowledge a broad range of responsibilities.

### **Executive remuneration**

The debate around executive remuneration illustrates a situation where companies have subscribed to sector-specific norms while breaching wider social norms. Public opinion has been highly critical of executive pay that is high both in relative and absolute terms. A number of high profile instances where shareholders have voted against remuneration policies at annual general meetings (AGMs) appear to

reflect primarily their discontent about pay not being well aligned with performance. In contrast, companies have seen themselves as setting remuneration to help achieve targets and paying what they thought competitive.

Though it may have no major direct interest in these companies, the public remains critical and its dissatisfaction is amplified by the media. The UK Government's response has been to introduce legal measures to strengthen shareholder rights in listed companies, although this may not necessarily address issues of social acceptability. Similar initiatives are being debated at European Union level.

The issue has also led to a wider debate. Commentators and executives have raised questions such as whether high remuneration is solely an issue for executives of public listed companies. What about executives and owners of large private companies?

### **Bank bailouts**

Banks have been criticised for operating recklessly and failing as a result. This went against the idea of a perceived business purpose of banks that they should safeguard customers' money and provide services that customers need and value. Banks, including those that failed, delivered shareholder wealth at least in the short term, but certain activities were seen as fundamentally at odds with their perceived business purpose and customer expectations. Their implicit reliance on government intervention to spend public funds to bail them out also went against the idea of what a banking business is about and showed a lack of understanding among the banks of the full range of their stakeholders. State bailouts and reduced lending to small businesses and individuals have had real financial consequences to a range of taxpayers who feel further let down by banks.

### **Short termism**

Hostility against short termism and praise for long termism reflect another social norm. The need to build business and investment practice around long-term decision making is one of the key points of the 2011–2012 Kay Review of UK equity markets and their impact on the long-term performance and governance of UK quoted companies. The European Commission has also been looking at how to encourage long-term investment to enable sustainable economic growth. While there is no explicit legal requirement for companies to operate with a long time horizon or for investors to invest for a long period at the expense of immediate short-term gains, broad support for the conclusions of the Kay Review indicates that society wants businesses to prosper over a long period of time. The report is also sceptical about frequent takeovers involving UK companies, seeing them as a reflection of a trading culture which regards companies as financial assets rather than entities with business purposes.

## Distrust of the listed company model

The increasing importance and acceptance of private equity ownership has been seen as a challenge to the dominant listed company model of business for some time. However, more radical, alternative ownership models have recently attracted widespread attention and been praised for promoting employee commitment and resilience in times of adversity. For example, employee share ownership is seen to play a role in increasing the proportion of long-term oriented shareholders in Europe.

This support indicates that there may be a range of stakeholders beyond external shareholders who are as fundamental to business purpose, and their recognition is called for. Through the Nuttall Review, the UK Government has started a campaign to diversify business models to ‘fundamentally change our economy to ensure long-term growth is strong and more evenly balanced’ and this has been broadly welcomed.

## Aggressive tax avoidance

Tax avoidance is not contrary to legal and regulatory requirements. However, where the practice is considered aggressive, then society has reacted against it on grounds of fairness. Public and media debate reflects a strong social norm that people and businesses should play their part in restoring public finances and act responsibly in difficult economic times.

## Lack of diversity

Recurrent calls to bring in mandatory quotas indicate that there is a social expectation that board representation should be fair: it must be rectified if one gender or certain social groups are seen to be under-represented. The issue fundamentally requires cultural change at several levels, including the private norms of companies that appear to be out of alignment with wider social norms.

## Legislative delays

Laws and regulations, particularly those designed to change business models and behaviour require lengthy processes to develop and, once enacted, they are difficult to enforce and keep up to date. Consequently, limited legislative measures have been implemented around the world in the area of governance in direct response to the global financial crisis that began in 2007. In contrast, the UK Corporate Governance Code, a more principles-based approach, has adopted a number of changes in the same period.

## CHALLENGES TO OUR PROPOSAL

Our proposal is different from conventional corporate governance thinking which tends to view companies in terms of their responsibilities to shareholders and investors. We therefore anticipate challenges and tackle some of them below.

### The proposal makes life too complicated

It is true that multiple corporate responsibilities are more complex to grasp and address than a responsibility to serve shareholders alone. However, we believe that it is better to acknowledge what is a real challenge. Ignoring other responsibilities does not diminish their importance and certainly has not helped companies that have downplayed them. Life, whether for individuals or organisations, is complicated because it involves accepting the need to balance different responsibilities.

### Expectation gaps cannot be eliminated

As the resources of companies are finite and there will be tensions between different responsibilities, companies will face expectation gaps that cannot be fully eliminated. We accept that this may be frustrating but would argue that ignoring the responsibilities that give rise to expectation gaps will not make them go away. Recognising these expectation gaps in fact might force companies to think how they can best allocate resources. It may also encourage companies to demonstrate how they have discharged their responsibilities within constraints.

### Responsibilities limit business opportunities

Recognising a broad range of responsibilities, including those related to social norms, may discourage businesses from remaining in markets where responsibilities are perceived to be too demanding for the benefits they bring. We agree that some companies will retreat to jurisdictions where wealth creation is less challenging. Equally, some companies may decide to exit certain markets because prevailing social norms in those markets are incompatible with other responsibilities. In other words, some companies and some market environments may be incompatible unless the companies or those environments change. However, such hard choices already exist and companies should be prepared to face them.

### Norms are not always right

Norms can be unreasonable, in conflict with each other, unethical or even corrupt. Indeed, other responsibilities are not necessarily without faults. Laws and regulations can be ineffective and stakeholders may have unrealistic or irrational expectations of business purpose. Companies sometimes need to make difficult decisions in relation to such responsibilities. For example, businesses operating in a market where corrupt practices are widespread may try: to change corrupt norms however long it might take; to go along with the norms but risk reputational and commercial damage as a result elsewhere; or to exit a market or activity altogether. Our proposal to recognise a full range of responsibilities surfaces such underlying tensions and allows them to be properly addressed.

### The position differs from the enlightened shareholder model

The enlightened shareholder model that was enshrined in the UK Companies Act 2006 requires the directors of a company to act to promote the success of the company for the benefit of its members as a whole, and in doing so to have regard to a number of different stakeholders. There is no definition of what needs to be done to satisfy the requirement 'to have regard to' and there are no formal sanctions against companies that disregard other interests.

However, we note that the differentiation between the enlightened shareholder value model and the stakeholder model has become less important than it appeared to be during the period of debate leading up to the Companies Act 2006. Companies appear to operate within the boundaries set by other interests and are penalised by consumers and media as well as shareholders if they disrespect other interests regardless of the precise wording of the Companies Act 2006.

### Many intermediaries are not interested in companies' responsibilities as long as they make money

There is much criticism of intermediaries whose activities are seen to focus on short-term financial gains and encourage a trading culture. Their interest in companies addressing a wider range of responsibilities is expected to be limited, in particular if it means sacrificing financial gains. While they may be in a position to influence company behaviour directly on behalf of those they represent, they are unlikely to share the concern for long-term prosperity of businesses unless they are part of an effective investment supply chain.

These challenges strengthen our view that companies need to bear the proposed responsibilities. We accept that it is hard for companies to stand up to pressure to maximise financial results and to try delivering on a full range of responsibilities. However, neglecting these responsibilities can directly lead to risks rather than helping businesses succeed simply by meeting hard law requirements.

## SUMMARY

We have raised the question of what companies should be responsible for in the light of challenges highlighted since the onset of the global financial crisis. We support an inclusive view of company responsibilities which brings clarity to these challenges. A company that is sensitive to the full range of its responsibilities obtains its license to operate: it can be more agile in adapting to the environments where it does business and should be better at anticipating and even eliminating potential expectation gaps. Addressing the full range of responsibilities will also provide companies with a solid foundation for building and maintaining trust.

Finally, our approach cautions against disproportionate regulatory interventions. Where companies actively address their own responsibilities, legislators and regulators can focus on developing hard law that is relevant and proportionate to specific needs and leave other needs to other more suitable approaches.

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