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Social Responsibility is All About Governance

As corporate social responsibility becomes a prominent issue for business leaders and oversight management teams, internal auditors should ensure that pertinent issues are included in their organization's risk management plan.

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Late in 2004, J.P. Morgan Chase & Co. (JPM) found itself under attack. The Rainforest Action Network (RAN), a not-for-profit environmental advocacy organization, launched a public campaign against the global financial services firm accusing it of "making a killing" from loans to companies with operations that threatened the environment. The news traveled quickly. The following day, a story in *American Banker* under the headline "JPM Downgraded and Slammed in Ads," combined a description of RAN's initiative with an account of an analyst's downgrade of JPM stock.

JPM was not alone. Citigroup and Bank of America also had been under pressure from RAN to adopt policies that would prohibit financing activities that could endanger fragile ecosystems. In the first half of 2004, these two banks announced environmental policies that RAN labeled "signs of hope." But JPM, which had committed to announce a policy by October, missed the deadline, triggering RAN's campaign.

Stories like this are often discussed under the heading *corporate social responsibility* (CSR). This term includes the concept that corporate decisions must bear in mind not only responsibilities to shareholders, but also to stakeholders — groups such as suppliers, customers, employees, governments, and community members who may be affected by what a company chooses to do.

The banks targeted by RAN quickly learned that CSR boils down to a discussion about corporate governance and the exercise of corporate power, and the need for an organization's board to recognize and oversee how the corporation handles CSR issues. A group of thought leaders at a recent conference on CSR sponsored by Harvard University's Kennedy School of Government noted that there is increasing pressure for directors to demonstrate that they have an adequate understanding of stakeholder interests and CSR issues. For internal auditors, too, the implication is clear: they must ensure that CSR is on the board's agenda as an active governance item.

MOVING TO THE MAINSTREAM

Why is CSR becoming a prominent issue for corporate leaders? The answer lies in the convergence of factors such as:

- **Globalization.** There are approximately 60,000 multinational corporations. Perceptions about the growing reach and influence of global enterprises has drawn attention to the impact of business on society. This has led to heightened demands for corporations to take responsibility for the social, environmental, and economic effects of their actions.
- **Loss of trust.** High-profile cases of corporate financial misdeeds have contributed to a broad-based decline in trust in corporations and corporate leaders. This has led to intensified scrutiny of corporate impact on society, the economy, and the environment, and greater readiness to assume — rightly or wrongly — nefarious corporate intent.
- **Civil-society activism.**The growing activity and sophistication of civil-society organizations has put pressure on companies to take CSR seriously. Feisty nongovernmental organizations (NGOs) such as RAN have influenced corporate decision making in areas such as access to essential medicines, labor standards, environmental protection, and human rights. The Internet has increased the capacity of these organizations to monitor corporate behavior and mobilize public opinion.
- **Institutional investor interest in CSR.** The growth in socially responsible investing has created institutional demand for equity in corporations that demonstrate a commitment to CSR. In 2004, US $2.2 trillion in assets — 11 percent of all assets under professional management in the US — were invested in professionally managed portfolios that used socially responsible strategies.

POWER AND ACCOUNTABILITY

When you scratch the surface of what is usually labeled "CSR," why do you find corporate governance? Think about what RAN was really after when it took on the banks. The immediate issue was minimizing environmental damage linked to bank-financed projects. But the activist organization was also forcing a deeper dialogue about how to constrain the power of the corporation; the limits within which the corporation should pursue shareholder interest; how decisions should be made to balance shareholder interests and broader social interests; and which parties should have a say in corporate decision making. This is the stuff of corporate governance — the formal and informal rules and practices that determine how corporate power is exercised, how corporate decisions are taken, and how corporate decision-makers are held accountable.

MAJOR TRENDS

The bottom line is that CSR is a sign that the rules of the corporate governance game are changing. Corporations are facing intensified pressure from a range of new players to be accountable for the social, environmental, and economic impact of their decisions. Four major trends are likely to emerge in this area that will have an important impact on directors and on the role of internal auditors in supporting them. There will likely be increasing:

1. Demands on corporations to give stakeholders a role in corporate governance.
2. Pressure on corporations to disclose more and better information about the management of social, environmental, and economic issues.
3. Regulation involving elements of corporate activity that currently are regarded as voluntary forms of social responsibility.
4. Interest by the mainstream financial community in the link between shareholder value and nonfinancial corporate performance.

With a growing number of stakeholders demanding influence over corporate decision making, organizations will have to become more sophisticated in making choices about with whom they will engage with in civil society. And once partners are selected, corporations will have to become more adept in terms of how they interact with influential interest groups.

Directors will have to be knowledgeable about, and watchful of, this governance process. Expect to see an increasing number of board committees focused on CSR and public policy and more attention paid to the establishment of board processes for overseeing stakeholder interests.

PRESSURE FOR DISCLOSURE

Corporations have begun to respond to heightened demands from stakeholders for reporting on social, environmental, and economic impacts in addition to the customary disclosure of corporate financial performance and risk. The number of companies worldwide producing significant corporate social reports has swelled from virtually none in 1990 to more than 1,500 today. Because corporate social reporting is at an early stage, a number of significant matters haven't yet been resolved.

Of special interest to internal auditors is the lack of social reporting standardization and assurance processes. The set of social reporting guidelines first published in 2000 by

the Global Reporting Initiative (GRI) — an international, multistakeholder process involving NGOs, the investment community, assurance providers, and regulators — has emerged as a de facto standard. As young as social reporting is, assurance of social reporting is younger still. The first social reporting audit standard was published in 2003 by a UK-based think tank, AccountAbility.

MORE REGULATION

As society's views evolve regarding acceptable standards of corporate behavior, items migrate from the realm of corporate discretion to regulatory compulsion. Child labor is an historical example, with others including minimum wage, statutory holidays, workplace safety, employment equity, racial discrimination, environmental protection, product safety, food labeling, and advertising of alcohol and cigarettes.

It is reasonable to assume that pressure to push things across the boundary from discretion to compulsion will intensify. Recent examples provide a sense of some areas in which this process is unfolding:

- The state of Maine passed legislation requiring manufacturers to share responsibility for recycling televisions and computer monitors.
- Canada passed a law making it easier to lay criminal charges against corporations for workplace health and safety violations. The British government has proposed similar legislation.
- Denmark responded to health concerns about trans-fatty acids, a common ingredient in processed foods, by enacting regulations limiting the amount of trans fat that may be used by food manufacturers.

One area that may be of particular interest to auditors is increasing regulation of corporate disclosure of nonfinancial information. For example:

- Canadian securities regulators introduced rules requiring listed companies to describe their fundamental social and environmental policies, and the steps they are taking to implement them.
- Great Britain plans to require publicly traded companies to disclose information related to the environment, social and community issues, employees, and customers.
- France has enacted rules requiring listed companies to report publicly against certain social and environmental indicators.

INTEREST BY THE FINANCIAL COMMUNITY

The mainstream financial community has been slow to acknowledge links between a corporation's nonfinancial performance and its capacity to generate a financial return to shareholders. There are signs that this may be changing. One indication was the recent decision by Standard & Poor's (S&P) to partner with the UK-based think tank SustainAbility and the United Nations Environment Program, to produce a biennial review of corporate nonfinancial reporting. S&P attributed its participation in the review program to the "growing importance of nonfinancial disclosure in the overall assessment of a company's risk profile." S&P said that the identification and management of social and environmental risks facing the corporation "should have explicit board oversight."

THE CHALLENGE AHEAD

To help organizations navigate the best possible path among the competing claims of shareholders and stakeholders, directors will have to deepen their appreciation of the relationship networks — social as well as financial — that sustain their company. They will also have to build their capacity to oversee the organization's response to intensifying demands for greater rigor in the management of, and disclosure of information about, social and environmental risks. Internal auditors, though their advice to the board and their assurance of the quality and completeness of the information used by board members for decision making, will play a central role in helping directors rise to this governance challenge.

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