



## Creating an effective board with the right skills

‘Creating a board with a good balance of skills is one thing; ensuring it operates effectively is quite another challenge. An effective board must have the emotional intelligence to engage well with the business to determine whether the vision is working.’

*Eddie Kilkelly, Managing Director, insynergi*

## Does social responsibility improve corporate value?

‘Most studies find a positive correlation between CSR and measures of firm performance, such as profits. However, correlation doesn’t imply causation. It may not be that CSR causes a firm to perform better, but instead that firm performance causes CSR – only firms that are performing well can afford to spend money on its other stakeholders.’

*Alex Edmans, Finance professor at London Business School and Wharton*

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Managing Director at ICGN

### Publisher

#### Lesley Stephenson

Tel: +44 (0) 1278 793300

Email: [lesley@governance.co.uk](mailto:lesley@governance.co.uk)

### News Editor

#### Katharine Jackson

Email: [katharine.jackson@governance.co.uk](mailto:katharine.jackson@governance.co.uk)



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## News

# FRC to focus on company culture and stewardship

Levels of compliance with the UK Corporate Governance Code have continued to increase and reporting has become more transparent and informative, with audit committee reports and diversity reporting particularly improved, according to the Financial Reporting Council's (FRC) annual review of developments in Corporate Governance and Stewardship for 2014.

The report assesses corporate governance and stewardship in the UK; reports on the quality of compliance with, and reporting against, the two Codes; presents findings on the quality of engagement between companies and shareholders; and indicates where the FRC would like to see changes in governance behaviour or reporting.

### Key messages

The report highlights the importance of good culture within organisations. Changing culture is not an easy task. The recent FRC guidance on risk management highlighted the need for boards to think hard about how they can better assess whether the culture practised within the company is the same as that which they espouse, particularly under pressure.

### Governance and reporting

Overall levels of compliance with the UK Corporate Governance Code continue to improve with full compliance by the FTSE 350 now at 61.2 per cent, and 93.5 per cent complying with all but one or two provisions. There have been improvements in audit committee reports, with good examples of greater transparency and informative reporting.

There has been very good progress on reporting on diversity policies in the FTSE 100 – 85 per cent now have a clear policy – but the FTSE 250, while improving from 20 per cent to 56 per cent, have more to do on this. The UK is on course to reach Lord Davies' target of 25 per cent FTSE 100 female directors in 2015, with 22.8 per cent of directorships now held by women. The percentage of female executive directors has started to rise, having stagnated at 5–6 per cent for many years. Improving the executive pipeline in relation to the wider diversity issue remains a priority.

### Stewardship and engagement

2014 has seen an increase in signatories to the UK Stewardship Code, now almost 300. Despite some increases in the quantity and quality of engagement, not all are following through on their stewardship responsibilities. There are some signs of improvement, with mandates increasingly referring to stewardship and reports of better proactive engagement by companies and investors over the 2014 AGM season. However, the FRC is concerned that signatories are not reporting effectively across the seven principles of the Code, appropriate explanations being a particular point of weakness, and are not keeping their statements against the Code up-to-date. Disclosures on conflicts of interest also continue to be of concern.

Increasing levels of concern have been expressed by companies and investors about the role of proxy advisors, particularly in terms of a perceived lack of engagement with companies and a box-ticking approach by them and investors, with inadequate consideration of company circumstances and explanations, combined with a lack of engagement which should assist with their understanding of why a company has taken a particular approach.

### Next steps

In 2015 the FRC will continue to focus on the issue of company culture and behaviours, as well as the application of the Stewardship Code and the role of proxy advisors. They will also assess how effective boards are at establishing company culture and practices and embedding good corporate behaviour, and will consider whether there is a need for promoting best practice. They will continue to address emerging governance issues while assessing the impact of recent Code changes.

Key issues for consideration by companies and investors in 2015 are: the importance of good corporate culture and embedding sound governance behaviours throughout companies; board composition and ensuring suitable succession planning is in place; effective board evaluation and reporting; active engagement between boards and investors and improved reporting in this area; early consideration of the new viability statement; maintaining effective risk management and internal controls; focusing on the quality of explanations under both Codes; and committing to clear and concise reporting.

Areas of focus for the FRC's corporate governance team in 2015 are:

- Company culture: how best to assess culture and practices and embed good corporate behaviour throughout companies.
- 'Comply or explain': pursuing better explanations by re-stating the benefits of this approach and encouraging better explanations.
- Succession planning: continuing work and publishing a discussion document.
- Stewardship Code: promoting the benefits of stewardship and increasing scrutiny of adherence to the Code in order to improve the quality of practice and reporting.
- Proxy advisors: considering what role the FRC might play in overcoming communication problems in this area.

For the full review go to: <https://frc.org.uk/News-and-Events/FRC-Press/Press/2015/January/FRC-reports-on-better-compliance-with-UK-Corporate.aspx>

## News

# Boards still not prioritising social media

Boards are still not grasping the importance of social media and prioritising it adequately enough, according to the sixth FT-ICSA Bellwether report. The findings, *Insights into what boards are thinking from the survey of FTSE 350 company secretaries*, show how boards are positioning themselves to address the challenges of the economy and the wider business and social climate in which they operate.

### Corporate boards

There is still growing confidence that Lord Davies' target of 25 per cent women on boards by 2015 will be met, although there is noticeably less confidence that the pipeline will be sufficient for the future. In terms of wider diversity, there is significantly greater confidence in the business experience and geographical diversity of boardrooms, but less in the diversity of their educational background. However, doubts about the future pipeline call into question the quality of succession planning and the role of the nomination committee. There is a risk that, if the trend to increased boardroom diversity significantly slows or even reverses, there will be increased political pressure to take action perhaps in the form of quotas, and it is good to see that a number of companies are putting plans in place to meet the target. Most companies now have a plan for engaging with their shareholders.

### Risk

Boards' approach to risk reporting and management varies. A wide variety of compliance and risk issues are discussed and reputational risk is regarded as a significant risk issue. However, although some work has been done on cyber risk, there has been little focus on social media. The perception of cyber risk as a major business risk has increased and companies are more active in mitigating it, with the help of the Government's 'Ten Steps'. However, although social media has been an increasingly hot topic in the press and among some advisers, relatively few companies have a social media policy which has been discussed at board level and many companies regard social media as unimportant despite the reputational risks associated with it. According to the survey, 49 per cent of the respondents stated that their boards had not discussed social media strategy at all; 25 per cent said social media is unimportant at board level; while only 31 per cent stated their boards thought that it is important.

### Governance issues

The new requirement for a strategic report prompted companies to think differently about the information that they included in their annual report, although the requirement does not seem to have struck a particular chord with investors. Compliance with the new rules on remuneration reporting was

more difficult than expected, despite the widespread publicity given to the changes, and the reports are now regarded as significantly more difficult to prepare. Proxy advisors are still regarded as a negative influence by the majority of companies. The overwhelming majority, but not all, of FTSE 350 companies offer direct or indirect employee ownership.

To see the full survey report go to: <https://www.icsa.org.uk/products-and-services/knowledge-and-guidance/research/ft-icsa-boardroom-bellwether>

## World's top 100 sustainable companies

The annual Global 100 list of the World's top sustainable companies was released at the World Financial Forum in Davos, Switzerland. The list ranks major corporations based on their environmental and corporate governance performance, taking into account a wide range of factors including relative energy and water consumption, greenhouse gas emissions, waste production, CEO-to-worker pay ratios, and board and management diversity.

Compiled by *Corporate Knights* magazine, a list of more than 4,600 global companies with market capitalisation of more than \$2 billion (US) is cut down to a shortlist of about 500 firms that have sufficient disclosure of the key metrics. Companies are compared with others in the same industry, rather than across the whole universe.

Topping the Global 100 list 2015 is Biogen, a US biotechnology firm, US pharmaceutical company Allergan is in second place, German sportswear company Adidas has finished third, with Singaporean real estate corporation Keppel Land and Finnish retailing conglomerate Kesko, completing the top five. The US has the highest number of companies on the list, with 20, Canada and France are next with 12, followed by the UK with 11. Some of the Canadian companies on the list work in the resource extraction business, not usually given high marks for sustainability, but these firms do notably well in the governance measures, particularly linking top executive pay to corporate sustainability targets.

Once the list is broken down by country, jurisdictions known as sustainability heavyweights outperform other similarly sized countries, a group that includes Germany (with five companies on the list), Sweden (four), Norway (three), Netherlands (three) and Denmark (three).

For more information go to: [www.corporateknights.com/reports/global-100/](http://www.corporateknights.com/reports/global-100/)

## International

# Barriers to board effectiveness in the Gulf

Greater skill, diversity and evaluation are required to enhance board contributions and support company and economic growth, according to the Gulf Cooperation Council (GCC) Board Directors Institute fourth biennial Gulf Board Effectiveness Survey.

The survey, *Promoting Professional Directorship*, which polled board directors from across the six GCC countries, highlights the challenges facing GCC boards today as well as identifying the best solutions for enhancing effectiveness and the contribution boards and their directors can make. Despite positive progress, a strong majority still believe that GCC boards are not as effective as they should be, 60 per cent saying that boards in the Gulf were only moderately effective and a further 12 per cent finding boards altogether ineffective. Effectiveness was judged against six main criteria: board composition and directors' capabilities; directors' duties and responsibilities; board structure, processes and protocols; delivery on roles of the board; board dynamics; and board evaluation and renewal.

### Top three barriers to board effectiveness

#### *Board composition and directors' capabilities*

Seventy-one per cent cited this as the first most significant barrier to board effectiveness. The major factors identified as areas for improvement were directors' skills relating to corporate governance and compliance (69 per cent), performance and talent management (48 per cent each) and risk management (44 per cent). While the survey revealed positive support for the training of directors, particularly new directors, 80 per cent of respondents said that there is still no formal development programme in place for new board members.

The need for greater diversity was a strong emerging theme: 65 per cent believed boards would benefit from a greater number of independent directors, despite 38 per cent commenting that no independents were presently on their boards. The need for more international board members was also advocated, 67 per cent of respondents believing the presence of directors from outside the GCC would bring more formality to the table and enhance the level of discussion. The survey also revealed the need for greater gender diversity on boards: while women still comprised on average less than one per cent of board seats, 56 per cent of respondents acknowledged the value that gender diversity brings to a boardroom in terms of enhanced interactions in meetings, discipline in discussion, effective probing and conflict management.

#### *Board evaluation process*

The second most commonly cited barrier to effectiveness was the absence of a formal board evaluation process (47 per cent). According to 62 per cent of respondents the main boards on which they serve still have no formal review process in place, which falls considerably short of global best practices. In Europe around 70 per cent of boards review their performance annually and disclose the results of this evaluation in their annual report; while in the United States, for

example, the New York Stock Exchange requires all listed entities to conduct an annual board performance review.

#### *Ineffective board dynamics*

The third most cited hurdle to board effectiveness was the impact of ineffective board dynamics (44 per cent). This included a perceived decrease in the level of preparation and participation in meetings: only 41 per cent of respondents agreed or strongly agreed that all members make meaningful contributions during board meetings. Although significant improvement is needed, directors seem to be taking a more critical view of their duties and rising expectations on the levels of acceptable participation.

### Positive trends

There was a continued decrease in cross-board representation, 23 per cent of respondents now sitting on one board and about half sitting on two or three boards; only 17 per cent acknowledged sitting on five or more boards. There were positive views on the overall decision-making process: 73 per cent of respondents said that GCC boards are able to reach closure on difficult topics indicating that the decision-making process is considered transparent, fair and efficient by a strong majority. There was also progress around the role of the chairman, 60 per cent of respondents indicating that their chairman now achieved the right balance between being sufficiently informed and present while not interfering with management. Only 19 per cent believed the chairman was too involved.

### Recommendations

Six areas for improvement are highlighted and recommendations made for boards in the region:

1. make training for new and incumbent board members mandatory;
2. replace ineffective board members and rotate board members more frequently;
3. appoint more international and independent board members;
4. strengthen the board secretary role, a critical role in ensuring board effectiveness;
5. dedicate more time in the board agenda to talent management and risk management; and
6. conduct annual board evaluations.

Board effectiveness is critical to achieving growth and to maximising the potential of Gulf companies and the economies of the region overall. For growth to be sustainable and to positively impact all stakeholders, good governance must continue to be strengthened.

For the full survey report go to: <http://gccbdi.org/wp-content/uploads/2013/09/Promoting-Professional-Directorship-2015-Eng.pdf>

# Global News

## GRI creates corporate leadership groups

The Global Reporting Institute (GRI), a pioneer in the development of sustainability reporting and global standard-setter for sustainability disclosures, is convening leading organisations to form two Corporate Leadership Groups: Reporting 2025 and Integrated Reporting.

### Reporting 2025

GRI has launched Reporting 2025 to promote an international discussion about the purpose of sustainability reporting and disclosures looking ahead to 2025. Over a 12-month period, thought-leaders in various fields will be interviewed on subjects ranging from data technology to society and business development scenarios with the aim of identifying main issues that will be, or should be, at the centre of company agendas and public reports. The Corporate Leadership Group will play a crucial role in advancing the discussion in the Reporting 2025 project. Group activities will take place in two phases: the first phase is designed to help identify trends:

- What will be the most important topics for society in the next decade and how will they affect businesses and disclosures?
- How will new technologies and big data influence the reporting process?
- How will organisations connect sustainability efforts to value creation?
- How will businesses communicate about sustainability in the future?

In the second phase, the Group will explore the key themes further, helping to set Reporting 2025's agenda for 2016.

### Integrated Reporting

GRI believes that integrated reporting, which incorporates material sustainability information equally alongside financial information and which embodies a truly multi-stakeholder approach, provides reporting organisations with a broad perspective on risk. Organisations who have already produced a GRI sustainability report frequently ask for additional direction in the area of integrated reporting. To address this, GRI is convening a group to stimulate discussion on how to leverage existing robust sustainability practice for the purpose of integrated reporting. The establishment and activities of a Corporate Leadership Group will play a central role in enriching existing discussions on integrated reporting. Members of the Group will help to address practical questions, such as:

- How do sustainability reporting and integrated reporting interact?
- How can a multi-stakeholder approach be achieved in integrated reporting?
- How can reporting organisations use G4 in preparing integrated reports?

Any organisation interested in joining these groups should contact GRI.

For further information go to: <https://www.globalreporting.org/information/news-and-press-center/Pages/GRI-CREATES-CORPORATE-LEADERSHIP-GROUPS.aspx>

## NZ FMA governance guidelines update

Following consultation last year, the Financial Markets Authority (FMA) in New Zealand has updated its corporate governance guidelines, aimed at helping directors and their advisers decide how best to apply the nine key corporate governance principles. The revised guidance, *Corporate Governance in New Zealand Principles and Guidelines: A handbook for directors, executives and advisers*, takes into account corporate governance trends and developments and is a stop gap pending a more substantive review to capture the OECD updates scheduled for later this year. Changes include:

- emphasis on the need for board 'ownership' of corporate governance processes and continuous review and monitoring – a tick-box approach can arise when boards delegate responsibility for compliance wholly to management;
- recognition of the increasing use of website portals for investor relations with a suggestion that these can be used for real-time compliance reporting on governance principles (together with, or instead of, reporting in the annual report);
- some more detailed recommendations on board composition, including how to secure the right mix of skills, capability and independence (and what independence means in practice) and a

reflection of the developing market practice of adopting specialist board committees focused on workplace health and safety;

- a discussion of the need for better risk management and regular communication to investors around risks and risk management; and
- an increased focus on business ethics and diversity issues for boards.

A particularly welcome addition is greater recognition by the FMA that corporate governance processes must be 'right-sized' for the circumstances of particular firms, rather than a 'one-size fits all' approach.

Although not legally binding, the FMA encourages a range of organisations, including listed issuers, Crown organisations and not-for-profits to follow the guidelines. Given this broad audience, the guidance is necessarily 'high level' rather than prescriptive and not all of it will be relevant to every organisation. Accordingly, FMA suggests boards explain to their stakeholders how they apply the guidelines rather than 'comply or explain why not'.

For the revised guidance and principles go to: <https://www.fma.govt.nz/assets/Report-and-Papers/Consultation/Corporate-Governance-Handbook-Principles-and-Guidelines.pdf>

## Top Priorities for Corporate Boards in 2015

Keeping pace with the changing risk management landscape is nothing new for corporate boards, but leaders are facing a variety of challenges that, if not properly overseen, may impact their organisation's reputation. To help boards and investors be aware of and prepare for these challenges, the EY Center for Board Matters has published its Top Corporate Board Priorities for 2015.

### *Board composition and turnover*

Board composition and renewal is one of the key priorities going into the 2015 proxy season and many institutional investors do not believe that companies are doing a good job of explaining in the proxy statement why they have the right directors in the boardroom. Attention to succession planning can help ensure the board includes directors with a balanced level of institutional knowledge and fresh perspectives and may help defend against activist investors attempting to exploit perceived weakness in board composition.

### *Pressure from shareholders*

More pressure will be put on boards by shareholders to explain their current practices and adhere to the highest standards of corporate governance. These pressures may come through engagement, letters to the boards, submission of shareholder proposals, or proxy voting decisions. Based on EY Center for Board Matters corporate governance data, about 40 per cent of shareholder proposals submitted to date focus on environmental and social topics. There will also be a significant increase in shareholder proposals asking for implementation of proxy access procedures.

### *Improving disclosures*

Regulators and standard setters are increasingly focused on making business and financial disclosures more effective and the quality of disclosures around how boards are carrying out their oversight responsibilities – including strategy, risk, management and CEO succession, audit and compensation – is expected to improve in 2015. More companies will present information clearly and concisely

in graphs, charts and tables and, long-term, technology is expected to play an important role in disclosure reform.

### *Regulatory cooperation*

Although a constant challenge, 2015 will continue to see more cooperation between regulators in Western and developing markets. Already the Public Company Accounting Oversight Board (PCAOB) and its Chinese counterpart are beginning to make some progress with information sharing and creating an environment for consistent dialogue.

### *Human capital*

Emerging economies will continue to assume a greater share of global spending power. Many countries are experiencing explosive population growth, major demographic shifts or population declines and these trends will continue to have a far-reaching impact, ranging from growing pressure on critical resources to sweeping changes in goals and aspirations at a personal and social level. Effective board oversight is required to address emerging risks in this volatile environment.

### *Cybersecurity*

Board members are being increasingly held accountable for improperly managing cybersecurity risks and these risks will continue to escalate in 2015. Boards must set the tone for enhancing cybersecurity and determine oversight responsibility whilst at the same time giving their organisations the appropriate flexibility to embrace the power of technology. They must also make sure that board composition evolves to include leaders who deeply understand the business and IT risks associated with cybersecurity.

With the rapid rise of transformational technologies, digital risks and human capital challenges, boards need to effectively manage reputational risk on a global scale and board members' time commitment might increase in 2015.

For more information go to: [www.ey.com/boardmatters](http://www.ey.com/boardmatters)

## SGX releases new disclosure guide

The Singapore Exchange (SGX) has released a comprehensive disclosure guide. The guide, structured in a concise question-and-answer format, will not only help companies to comply with the country's governance regulations, but will also make it easier for investors to review and compare companies' governance practices, and better assess the companies in which they might, or already do, invest.

The new legal guidelines are in compliance with Singapore's Code of Corporate Governance, which was revised in 2012. While compliance with the Code amongst SGX-listed companies is generally good, disclosures relating to remuneration, risk governance, board diversity

and sustainability are not comprehensive. Using the disclosure guide as a basis for comparison, investors and interested stakeholders can judge whether a company has provided adequate disclosures and meaningful explanations for any deviations from the Code.

Though compliance is not mandatory for SGX-listed companies, they will still have to publish their governance practices in their annual reports: the 'comply-or-explain' approach still makes it mandatory to explain and justify any deviations from the Code in annual reports. The SGX also encourages listed companies to address the questions in the guide and include the answers, together with audited financial statements, in their annual report in order to provide shareholders and potential investors with a substantive performance review.

## Feature

# Creating an effective board with the right skills

**Eddie Kilkelly** explains why each member of the board must remain engaged and up-to-date even when operating at a strategic level if the board is to provide effective governance.

Effective boards share a number of characteristics that underpin high performance, collaboration and teamwork. Once the board has developed a vision for the future of the business and stated a clear and concise set of values that are easy to enact, it must take the crucial next step of developing people and their soft skills to deliver the vision while retaining clear governance over the organisation.

The goal is to combine the optimum mix of personalities and perspectives on the business, balancing knowledge and expertise among board members to create an effective board. All members must have a strong commitment to deliver the vision of the business. Most businesses, with just a couple of workshops, could develop a balanced plan with a shared vision and agreed corporate values – arguably this is the easy bit. Establishing trust and respect among the members of the board comes later and does not happen overnight.

Researchers have found that a combination of trust and oversight is key to high-performing teams – or boards. Researchers De Jong & Elfring confirmed this link, noting that leaders need to engage in managing interpersonal relationships and fostering trust among members. Creating a board with a good balance of skills is one thing; ensuring it operates effectively is quite another challenge. An effective board must have the emotional intelligence to engage well with the business to determine whether the vision is working.

There are four main questions that an effective board must continually ask. Is the plan working? Is the vision still the correct one or has the market changed? Do we have the right people and are they in the right roles? Is our business growing as well as it should? Even if the right building blocks are in place to have an effective board, to be effective the board must be constantly engaged and working well with people so that it can answer these four questions at any time to ensure good governance.

### Avoiding temptation

Even an effective board can make mistakes and there are major temptations lying in wait. There is a temptation to boil all the performance metrics down to one number – margin. If the profit margin is good, it is easy to think everything is working well but margin, despite being important to the business and

the shareholders, is rarely the best indicator of performance. In fact, a healthy margin can mask a lot of underachievement. The market might be buoyant so the company is growing its bottom line but in fact it might be underperforming in key areas.

Another temptation for the unwary is to overlay lots of controls, structures and levels of authority on to governance frameworks. There is a real risk of creating a straitjacket for the business that stifles innovation and becomes very expensive. If every time something goes wrong the organisation puts another control in place, before you know it nobody can move. There is a need to aim for a governance framework that strikes a balance and will enable both clear decision-making and flexible innovation.

### Choose the right projects

In order to be effective and to deliver good governance it is vital that the board has a blueprint for the future of the business. This should set out clear strategic objectives and all of the projects should cascade from them. If businesses choose to pursue the right projects that fit with the strategy then there is less likely to be disagreement and people will understand why certain decisions are being made.

Strategic projects are usually agreed at a high level but most businesses also run a number of more informal, under the radar, projects that can impact the ability of the organisation to pursue its strategic direction. An effective board can corral these types of project more easily if there is a clear and shared vision. For example, if an organisation plans strategy to expand into China, yet someone wants to launch a campaign to target another non-core region then this new project can be challenged on clear grounds that are understandable to everyone. Tactical projects are fine provided they are agreed and do not distract from what is important.

### Choose the right people

Businesses also need to have a clear set of unambiguous values and, from board level downwards, the right people to live these values. If organisational value statements are wordy or there are just too many values, then people will be unclear as to how they are supposed to behave. Simple value

statements are best – ‘deliver fast and do a great job’ is hard to misinterpret. It then becomes very easy to see whether the values are being demonstrated.

If it is difficult to find evidence that employees are demonstrating these values then perhaps the business may have the right people in the wrong roles. It is vital to consider how to display business values in any succession plan for bringing new people into the business, particularly in board-level roles.

**Ask the right questions**

With the right projects and people in place, the board can then move on to think about acting in a different way, to develop a flexible governance model and to engage with people effectively so that they can innovate, make decisions and adapt.

Board members can find it challenging to operate at a strategic level while trying to engage with people running projects at a detailed level. However, it is not appropriate to abdicate responsibility for the detail of projects in every case. Similarly, micro-management is rarely an effective strategy for members of the board. Unfortunately, there is no silver bullet. For effective governance, individual board members need to ask themselves constantly ‘How much do I need to know and how much detail is appropriate?’ The answer will change on almost every occasion.

The key question is: ‘Am I satisfied with the information in front of me?’ It is desirable to foster a culture where board members will challenge the figures provided and statements made until they are reassured. This way they are in a position to answer any questions their board level peers may ask at a later date or even respond to challenging questions raised at the AGM.

There is a real risk that the boardroom becomes an ivory tower and board members fail to engage with the business and consequently do not know the answer to key questions. If the board finds itself having to bring in people to answer key questions then it is failing to support effective governance.

**Emotional intelligence is key**

With an effective board in place, growing the business becomes more about developing people. At this stage, focusing on emotional intelligence is critical. Emotional intelligence is a soft skill that business leaders can develop, improving their own skills when it comes to engaging with the team and identifying capabilities and personal strengths. This way the business is in a strong position to move people out of their comfort zone and develop the future capabilities that will drive innovation.

Emotional intelligence is also needed to help identify gaps at board level and dealing with any issues. If everyone on the board is objective, competitive, demanding and likes a challenge and there is no-one focused on ideas and

innovation, then the board has a blind spot that could compromise effective governance. If there is no-one who is highly analytical, loves detail and wants to understand how everything works then, again, there is a weakness in the board. Succession plans should seek to plug those gaps, looking not just at knowledge and expertise but also at personality traits and perspectives.

Board members may have made it to the board based on technical track record or business success but once there the focus should switch to soft skills and emotional intelligence. Hard frameworks, bound by defined structures setting out who manages whom, objectives and KPIs measuring outcomes, are now superseded by a softer approach comprising networks (who do we engage with, who solves problems?), people (who is over performing and who is underperforming?) and asking the right questions to tease out the ‘unsaid’.

An effective board needs a balance of knowledge, a balance of personalities, commitment and shared values in order to engender respect. The key is to focus on engagement, delivering the business through people using soft skills.

Five parameters for an effective governance framework:

1. A governance framework should contain guidelines and not rules. There needs to be flexibility without constraint.
2. There should be visibility and transparency so that there is a clear view of progress and of decisions being made.
3. Ownership needs to be defined so that it is clear who was involved in each decision.
4. There should be a process that allows fast track decision-making. Enabling an executive board to make a same-day decision on an urgent project approval.
5. A governance framework should encourage innovation and allow people to think outside the box. Businesses want consistency and that is one reason they have governance in place but they also want innovation and it is not easy to have both – they have to work hard at it.



*Eddie Kilkelly is Managing Director at insynergi. He has been involved in the Best Practice and Change Management industries for two decades. During this time he has worked as a Project and IT Service Manager, an implementation consultant providing support to organisations who have adopted the use of Best Practice methods including PRINCE2, MSP and ITIL and a coach and mentor to senior project and programme leaders and project sponsors. Eddie’s objective is to help organisations achieve their objectives through effective management of change by empowered and confident people.*

*Eddie can be contacted at [eddie.kilkelly@insynergi.org](mailto:eddie.kilkelly@insynergi.org) or visit [www.insynergi.org/](http://www.insynergi.org/)*

## Feature

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# Does social responsibility improve corporate value?

**Alex Edmans** takes one particular dimension of social responsibility, which he argues has been independently verified, to present his arguments.

When companies make decisions, should they care only about shareholders or should they take other stakeholders (eg employees, customers, the environment) into account? This is a decades-old debate, but despite many cogent views on both sides, there's surprisingly little hard evidence.

In 1970, Milton Friedman famously wrote that 'the social responsibility of business is to increase its profits'. This view isn't as hard-hearted as it may sound. Friedman argued that a company can only increase its profits by taking other stakeholders into account – producing high-quality products, treating its employees fairly, and having a good environmental reputation. Under this view, firms should focus exclusively on profits, and everything else will fall into place. Considering other stakeholders beyond the profit implication is at the expense of shareholders: a dollar spent on reducing pollution (beyond the level that will avoid an environmental lawsuit) is a dollar that cannot be paid as dividends.

However, advocates of CSR argue that the Friedman view only holds in theory. In practice, it's extremely difficult to quantify the profit implications of most socially responsible actions. A company could decide whether to grant an employee compassionate leave by trying to calculate the potential loss in morale and productivity if the leave was withheld, but these consequences are very hard to quantify. The CSR approach would be to grant the leave simply because it's the right thing to do – because the goal of the company isn't only to maximise profits, but to treat stakeholders with compassion. Treating employees fairly will eventually manifest in greater staff retention and future productivity. However, these long-run effects are difficult to quantify, so a firm focused exclusively on profits will not invest in its stakeholders.

Whether CSR improves firm value has been studied extensively by management scholars. Most studies find a positive correlation between CSR and measures of firm performance, such as profits. However, correlation doesn't imply causation. It may not be that CSR causes a firm to perform better, but instead that firm performance causes CSR – only firms that are performing well can afford to spend money on its other stakeholders. In addition, some studies

consider only one industry, or a short time period, and so are hard to generalise.

I decided to tackle this long-standing management question using a methodology from a different field – finance. This approach involves linking CSR not to profits, but to future stock returns, which reduces reverse causality concerns. If it was high profits that caused CSR, then the high profits would mean the company's stock price would already be high today, and so we shouldn't expect higher stock returns going forward.

The next decision is how to measure CSR. The main challenge is that CSR is extremely difficult to measure objectively, as it's intangible. Tangible measures do exist – for example, one could measure workplace diversity by whether there's a minority on the board. However, tangible measures are relatively superficial and thus easy to manipulate. For example, a company that cared little about workplace diversity could put a token minority on the board to 'tick the box'. A separate challenge is that CSR comprises of many different dimensions – responsibility to employees, customers, the environment etc, and it's unclear how to weight these different constituencies.

I thus focused on one particular dimension of social responsibility – employee satisfaction. I chose this dimension because a very thorough measure of it exists. Since 1984, there has been a list of the '100 Best Companies to Work for in America'. This list is compiled by surveying the employees themselves – it's the ultimate in fundamental, grass-roots analysis. Two hundred and fifty employees are randomly selected in a firm and asked 57 questions on various aspects of employee satisfaction (credibility, respect, fairness, pride/camaraderie), which had been developed through extensive discussions with managers, employees and workplace experts. As a result, it's arguably the most respected measure of employee satisfaction. Equally importantly, it has been available since 1984, and thus I have a long time-series which comprises both recessions and booms.

The first list came out in a book in March 1984, then another book in February 1993, and then in the January edition of

Fortune magazine every year from 1998. My methodology involves in looking at Best Companies in April 1984, rebalancing the portfolio in March 1993 to take the new list into account, and then rebalancing it every February from 1998. The one month delay is because I wish to test not only that employee satisfaction improves firm value, but also whether the market recognizes this link. Even if employee satisfaction improves firm value, my strategy should earn no returns if the market recognizes this link. As soon as a company appears in the Best Companies list, its stock price should go up, so I shouldn't be able to generate returns by buying it one month too late.

I compare the returns of the Best Companies not only to the overall market, but also to companies in the same industry. For example, Google is frequently in the Best Companies list, but its high returns could be due to the tech industry doing well, rather than its employee satisfaction. I also compare each company to peer firms with similar characteristics (eg size, dividend yield, recent performance, valuation ratios). In short, I try to control for as much as possible, to isolate the effect of employee satisfaction. I also remove the effect of outliers, to ensure that any superior performance of the Best Companies isn't due to a few star performers such as Google.

I find that the Best Companies beat the market by 2–3%/year, over a 26-year period from 1984–2009. This outperformance is highly statistically significant, and also economically meaningful – a fund manager who beats the market by 1%/year for five years is considered to be skilled. Moreover, this outperformance is based on a very simple trading strategy using public information on large firms.

The results have three main implications. First, they suggest that employee satisfaction is beneficial for firm value. While it may seem natural that companies should do better if their workers are happier, this is far from obvious. Indeed, the 20th century way of managing workers is to view them as any other input – just as managers shouldn't overpay for or underutilise raw materials, they shouldn't do so with workers. High worker satisfaction may be a sign that workers are overpaid or underworked. However, the world is different nowadays. Human capital is the main asset in many firms, and employee welfare can improve productivity, retention, and recruitment.

Second, even though employee satisfaction may be beneficial in the modern firm, the market doesn't recognise this link.

Even though I wait a month before forming my portfolios, the strategy generates superior returns.

Similarly, the Best Companies typically report earnings that beat analyst expectations – analysts aren't aware of the benefits of worker welfare. Indeed, I show that it takes 4–5 years before the market fully incorporates the value of employee satisfaction. This may be because traditional methods of valuing companies are based on the 20th century firm, and emphasise tangible factors such as short-term profits. This result has broader implications for firms' incentives to invest for the long-run. If investors continue to value companies based on short-term profit, then managers will pursue short-term profit rather than long-run growth.

Third, Socially Responsible Investing (SRI) – incorporating social considerations into portfolio choice – can add value. The traditional view is that SRI is costly to investment performance, as it involves screening out good investments and screening in bad investments. However, the Best Companies strategy generates high returns while supporting companies who treat employees responsibly – investors can do well and do good. This result is a consequence of the first two implications – employee satisfaction is beneficial (the first implication) but the market doesn't recognise that it's beneficial (the second implication).

In conclusion, it's worth highlighting some caveats to my study. First, I've only shown a link between stock returns and employee satisfaction, and not other dimensions of CSR. Further research must be done to study whether there's any link with environmental protection, animal rights, etc. However, since the traditional view is that no dimension of CSR should add value, the results are an important first step towards demonstrating the benefits of CSR more broadly. Second, while I control for many observable factors (industry performance, firm size, dividend yield, etc), I can't rule out the explanation that an unobservable variable (eg good management) causes both employee satisfaction and superior returns. If so, my first implication is no longer causal – improving employee satisfaction (without changing management) won't improve stock returns. However, the other two implications remain. It remains the case that the stock market misvalues intangibles – just that the intangible being misvalued is good management rather than employee satisfaction. It also remains the case that a socially responsible



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investor could have bought companies that treat their employees well and earned superior returns.

*This article was previously published in the World Economic Forum.*

*Alex Edmans is a finance professor at London Business School and Wharton. He authors the blog, 'Access to Finance' ([www.alexedmans.blogspot.com](http://www.alexedmans.blogspot.com)), which aims to make complex finance issues accessible to a general audience. Twitter: @aedmans.*

**Further reading:**

Edmans, Alex (2011): 'Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices'. *Journal of Financial Economics* 101(3), 621-640

Edmans, Alex (2012): 'The Link Between Job Satisfaction and Firm Value, With Implications for Corporate Social Responsibility'. *Academy of Management Perspectives* 26(4), 1-19

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**Designed and printed by**

**Kolor Skemes Limited**  
Riverside Studio, Gills Lane, Rooksbridge, Somerset, BS26 2TY

**ISSN 1358-5142**

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