

ACCOUNTANTS FOR BUSINESS

Risk and reward: shared perspectives

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ACCA (the Association of Chartered Certified Accountants) is the global body for professional accountants. We aim to offer business-relevant, first-choice qualifications to people of application, ability and ambition around the world who seek a rewarding career in accountancy, finance and management.

Founded in 1904, ACCA has consistently held unique core values: opportunity, diversity, innovation, integrity and accountability. We believe that accountants bring value to economies at all stages of their development. We seek to develop capacity in the profession and encourage the adoption of global standards. Our values are aligned to the needs of employers in all sectors and we ensure that, through our qualifications, we prepare accountants for business. We seek to open up the profession to people of all backgrounds and remove artificial barriers, innovating our qualifications and their delivery to meet the diverse needs of trainee professionals and their employers.

We support our 140,000 members and 404,000 students in 170 countries, helping them to develop successful careers in accounting and business, based on the skills required by employers. We work through a network of 83 offices and centres and more than 8,000 Approved Employers worldwide, who provide high standards of employee learning and development. Through our public interest remit, we promote appropriate regulation of accounting and conduct relevant research to ensure accountancy continues to grow in reputation and influence.

ABOUT ACCOUNTANTS FOR BUSINESS

ACCA's global programme, Accountants for Business, champions the role of finance professionals in all sectors as true value creators in organisations. Through people, process and professionalism, accountants are central to great performance. They shape business strategy through a deep understanding of financial drivers and seek opportunities for long-term success. By focusing on the critical role professional accountants play in economies at all stages of development around the world, and in diverse organisations, ACCA seeks to highlight and enhance the role the accountancy profession plays in supporting a healthy global economy.

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The challenge for business entities of all kinds is to ensure that the business rewards they seek are supported by sensible management of the risks that confront them.

Those who govern entities are responsible for ensuring that they pay due attention to all material risks, including ethical and behavioural risks.

This paper contains a number of individual perspectives on these themes.

Risk and reward: shared perspectives

The Council of the Association of Chartered Certified Accountants consider this study to be a worthwhile contribution to discussion but do not necessarily share the views expressed, which are those of the authors alone. No responsibility for loss occasioned to any person acting or refraining from acting as a result of any material in this publication can be accepted by the authors or publisher. Published by Certified Accountants Educational Trust for the Association of Chartered Certified Accountants, 29 Lincoln's Inn Fields, London WC2A 3EE.

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Foreword

In 2010 ACCA published *Risk and Reward: Tempering the Pursuit of Profit*. That paper explores the nature of the dynamics that drive corporate planning and accountability, focusing on the broad range of risks which need to be identified and managed.

One of the areas of risk that warranted particular attention, the paper suggests, is the matter of behavioural risk. It argues that while guidance, standards and supervision undoubtedly have a role to play in regulating corporate activities, those activities are ultimately the result of the behaviour of companies' lead actors. That paper contends that, whether regulatory standards of various kinds are framed as rules-based or principles-based, what will always be of fundamental importance is the preparedness of companies to apply them honestly, ethically and transparently.

Accordingly, if business is to be conducted in a way which is going to be consistent with the interests of investors and wider society, more attention needs to be paid to how this issue of behavioural risk can be interwoven with regulatory mechanisms so as to ensure, as far as is practicable, that directors and executives act in accordance with the spirit as well as the letter of law and standards.

ACCA is pursuing this agenda in its own activities and on behalf of its members by promoting the concept of 'public value'. This entails acting not only in the public interest but also in a way which delivers added value to stakeholders through, for example, good corporate governance, enabling access to finance or protecting clients' wider interests.

In this follow-up paper, we offer a collection of individual perspectives on the issues explored in that earlier study. We look at how investor groups see the significance of risk and pose the question of whether it is feasible to expect commercial businesses to operate in accordance with some conception of the 'public good'. We also broaden out the scope of the earlier paper by acknowledging that the issue of behavioural risk impacts on the public sector just as it does the private sector. A number of contributions address the application and measurement of ethical principles and consider how those principles might impact on performance.

ACCA thanks all the authors for submitting their work and trusts that it will prove a thought-provoking contribution to the debate.

John Davies

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March 2011



1. Capitalism and the concept of the 'public good'

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What shocks you? After corruption scandals involving politicians, failed and failing pensions, eye-watering sums to bail out banks and slightly smaller but still eye-watering bonuses in the financial sector, our capacity for outrage has been dulled. There is a sense of resigned acceptance that there is little that people can do about it and that we and future generations of taxpayers will be worse off for years as a result. Such acceptance is tempered with a growing cynicism and lack of trust in politics, finance and business.

Following years of industrial unrest in the 1970s, when business was branded by many as a villain, a widespread view emerged in the 1980s that free markets were a good thing, and that the less business and finance were regulated the better it would be for society as a whole. Financial services became the engine of growth. Economic prosperity increased for most people but the gap between rich and poor widened dramatically. Then came the crunch. We still do not know whether the financial crisis caused just a nasty but relatively short blip in economic growth or is still causing something worse. It does, however, seem already to have claimed many innocent victims across society, including elderly people trying to live off the interest from savings.

It is now clear that an unfettered market may not be the best one. As has happened before, after Enron collapsed, there is more talk now about ethics. But, apart from saying there was too much greed, it has been difficult to point to any particular ethical failing, except where we know that laws were broken. We know that following the rules does not necessarily equate with good ethics. In fact, we have seen many examples where practices that failed the test of public acceptability were met with the defence that 'we were following the rules'. Unfortunately, gaming-the-rules rather than playing-by-them became common.

Capitalism cannot exist without society, and society wants or needs capitalism to raise standards of well-being. In an ideal world there would be a yin-yang relationship between capitalism and society, where capitalism benefits society and society enables responsible capitalism to flourish. Unfortunately some see society as, in effect, capitalism's prey and this fits well with our 'want it now' culture. The image of a hunter who 'eats what s/he kills' makes a poor metaphor for business – it corrodes trust; a better one is of a farmer who grows food and husbands livestock while looking after the environment. This approach builds trust and that is good for business and for society, and it necessitates a long-term approach.

RULES AND REGULATION

How could we bring this about? The response of governments, indeed almost anyone in a position of authority, is to think about making more rules. But having more rules is not the answer, the financial crisis having exposed their limitations. A compliance mind-set meant that people did not have to worry about whether something was right or wrong or even sensible. The shadow banking system, the massive build-up of debt and leverage might not have happened if the Basel framework had not created the opportunity. The US Community Re-Investment Act of 1977, which outlawed discrimination by banks against low-income households, was also an unwitting catalyst for the crisis. There is also an argument that financial reporting and auditing standards have become too rigidly based on rules. The accounting profession is again questioning the purpose of accounting and auditing and asking whether it is sufficient to comply with relevant technical standards. The International Federation of Accountants is currently consulting on a public interest framework.

ACCA has long held the view that principles are more important than rules. Nonetheless, some people do not like principles on the grounds that they create too much ambiguity, while a few want to know what they can get away with. A principle such as 'substance over form' can seem too restrictive if there is the possibility that a court or disciplining body might say that a particular action was wrong. People like certainty about what they can and cannot do. The less well intentioned are, of course, entirely comfortable with principles if they are never enforced, so it is necessary that people can be held to account if they fail to uphold principles.

Have we reached a point where there are just too many laws and rules? Should we try to return to a situation where there is more emphasis on common law, where actions are interpreted according to precedent, principle and common sense rather than compliance?

MEASURING VALUE

Adam Smith divided incomes into profit, wage and rent. In profit-seeking behaviour, entities create value in a competitive environment by engaging in mutually beneficial transactions. This is the invisible hand that promotes the public good, irrespective of the intention of the profit seekers. In rent seeking, wealth is transferred from one party to another through the recipient's ability to benefit from special privileges conferred by favourable or ill-conceived regulation. Such privilege might include benefits from monopoly or oligopoly, quotas, licensing, regulation and state support. Rent-seeking behaviour does not add value, nor does it serve the public good.

These days, because legislation and regulation are so entwined with business, it is often hard to distinguish the two types of income. The fact remains though that rent seeking is likely to feature wherever 'profits' are made that are higher than can be explained by competitive forces alone. This clearly applies to the profitability of the banking sector. A shortcoming of our present reporting framework is that it does not distinguish between profits that are earned from value-creating behaviour in a competitive environment and transfers of wealth through rent-seeking behaviour. There is a role for the accountancy profession in developing new ways of measuring and reporting on value creation.

There are, however, problems with measurement. One such problem is that of achieving appropriate precision. Valuation of hard-to-value items, such as land during a recession or mortgage-backed securities during a credit crunch, cannot be precise; yet financial statements do not convey that some valuations may be little better than a guess. Another problem is that any information derived from comparison with social or economic measures can be misleading or dangerous. This phenomenon is sometimes known as Goodhart's Law after the economist Charles Goodhart. It means that a measure turned into a target for policy will lose the information content that qualified it to play the role in the first place.

A crazy example is a Soviet-style factory, which, given the target of producing as many nails as possible, produces lots of tiny useless nails and, when given a target based on weight, produces a few very heavy nails. This might sound like an argument for free enterprise but the phenomenon is prevalent in market economies and especially in areas

where governments want market forces to operate in a regulated environment. This includes banking and the health sector. The public sector is plagued with examples, such as a hospital that introduced a waiting list for going onto a waiting list, when healthcare-sector waiting lists became a target to be managed down. In banking, the Basel framework facilitated the shadow banking system and a dependency on credit ratings. In one of the few management accounting novels, *The Goal*, E. M. Goldratt shows how seemingly sensible production targets could lead to bottlenecks and to bankruptcy.

New thinking is needed. It is now widely recognised that a change in culture is needed and many people are aware of how difficult this is to bring about by regulation. The UK coalition government talks of a 'Big Society', an aspiration that is difficult to define. But what if our company law or corporate governance framework introduced an explicit requirement for boards and companies to work for the public good? This could sit alongside other aims such as making a profit.

THE PUBLIC GOOD

The Golden Rule, found in most of the world's religions, 'do to others as you would have them do to you', does not give any particular direction or steer. In general, most company and professional ethics frameworks and codes also do not give a clear direction: they lack a moral compass. Even those that are expressed in terms of values rather than conduct contain much ambiguity. It is too simple to say just 'do the right thing', but this is the essence of what we need.

A requirement to conduct enterprise for public good might do the trick. Everyone has a sense of what constitutes the public good. There may be occasions when one person's sense of public good may be another person's idea of public bad but, if the principle were enforced by the court of public opinion, it could be effective. Any bad should be outweighed by the good – at least as far as society at any time might judge what 'good' is.

Adam Smith said that 'by pursuing his own interest a person frequently promotes the interest of society more effectually than when he really intends to promote it'. He was cynical about the good done by people who effected to trade for the public good. We, however, live in an age of much greater transparency and openness. If we had an expectation that companies, which operate in society and

need a mandate from society to do so, should operate in the public good as they make profits, then companies will do that. There is no need to specify how much public good is done or how they should do it. Quality reporting about what is done should mean that companies that are effective in both making profit and doing public good will be rewarded. It is necessary, of course, that reporting must be true and fair and that glib, empty or misleading statements are dealt with and companies must restrain themselves from using such reporting as a public relations exercise. Our internet age, however, means that any inappropriate reporting is likely to be spotted quickly.

It may be better not to define the public good but leave it vague, because more definition could invoke Goodhart's Law and encourage people to 'game' it. The public good is not, of course, about economic good alone. While economic well-being is nice, other things are equally if not more important. Bhutan has the concept of Gross National Happiness and, theoretically at least, is governed so as to raise happiness. Unlike GDP, this is not one target but a basket of targets across nine areas so its susceptibility to Goodhart's Law should be limited.

Although securitisation of loans can serve a valuable public good in enabling people with funds to provide them to people wanting them, and for risk to be taken on by people best placed to do so, the system went off the rails. Financial institutions were able to pass bundles of debt and related derivatives to individuals and other institutions that had little idea of what they were buying. Those involved had every incentive to 'game' the system and no incentive to do a public good. It is hard to envisage how the resulting bean feast could have been described by anyone as being a public good; a requirement to work in the public good may have kered animal spirits when there was no other restraint.

The concept of public good gives a clear moral steer or compass but tremendous flexibility in how companies can contribute.

This idea may sound radical but the UK company law framework already went some way towards this when it adopted the 'enlightened shareholder' concept in the UK Companies Act 2006. The Act confers a duty on directors to promote the success of the company and, in the course of making their decisions to that end, are required by law to 'have regard' to a number of specific factors.

It is implicit that, in having such regard, directors do not cause the company to harm the community or the environment. An amendment to include explicit reference to the public good would merely provide a subtle but vital direction.

THE ROLE OF SHAREHOLDERS

At present this legislation can be enforced only by shareholders and such enforcement would be difficult to apply to the concept of protecting the public good. It is not clear how, if at all, boards pay attention to their responsibility to the 'enlightened shareholder'.

Given that a substantial proportion of the shares of our large listed companies are owned by institutional shareholders investing on behalf of millions of people, it is reasonable to expect such companies to operate in the public good. Most smaller businesses do this already. To a great extent, they rely on trust and common sense within the business rather than on detailed internal controls to operate. They are generally formed and evolve to meet a market need and in so doing contribute to the public good through Adam Smith's invisible hand; they are not usually able to exploit the benefits of oligopoly or game regulation. Nonetheless, a possible exception to the latter could be the super profits from property development during a period of credit expansion. This occurs as a result of the planning system, which for understandable reasons restricts development.

The next step would be to encourage institutional shareholders to take an active interest in how their investee companies work in the public good. This could be the missing part of the FRC's Stewardship Code. The UK Corporate Governance Code, which currently makes no explicit reference to ethics, and which arguably puts too much emphasis on compliance with provisions at the expense of upholding principles, could also include a main principle that companies work in the public good and require companies to report truly and fairly how they do so.

DOING THE RIGHT THING

Considering the public good would also provide a directional steer for regulation and supervision and could enable considerable reduction in regulatory complexity. Supervisory action taken transparently by reference to the public good should be simpler to enforce. A financial institution or company would have a clear test and would know it might have to explain its actions. Surely this would be better than slavishly checking compliance with a regulation that may well, in any case, have unintended and unfortunate consequences?

Finally there is the intrinsic satisfaction that most people derive from doing something good. The overall effect should be to promote trust, which in turn would promote enterprise and lead to a healthier, probably more prosperous and happier society and reduce the regulatory burden. It might even help to restore faith in politics.

2. Company law and the concept of corporate social responsibility

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The question ‘in whose interests should a company be run?’ is one that has sustained debate in company law circles for many decades. The central issue here is this: given that the company, though a privately owned vehicle, benefits from material privileges conferred on it by the society in which it operates, should not society, in return, expect the company to operate in accordance with norms of behaviour that the same society deems appropriate?

Increasingly we are seeing a recognition, in national legal systems, of the fact that companies do owe responsibilities to society beyond a duty to pay tax on their profits. The UK is one of the jurisdictions where this is happening.

The reform of the UK’s company law in 2006 has seen this concept of corporate social responsibility weaved into the expectations of company behaviour through the rules on directors’ duties. The reforms made in the Companies Act 2006 were intended to generate a subtle shift towards requiring directors to take into account wider societal factors while fulfilling their legal responsibilities. The new approach was labelled ‘enlightened shareholder value’, to differentiate it from the more traditional corporate concept of shareholder primacy. But does the reform that has taken place here amount to any real change in the way that company boards are expected to act, or is it merely a sop to stakeholder pressures that does not translate into any real change in practice?

It is not difficult to see that shareholders are entitled to have special rights within any company. It is they who set up the company in the first place, set its objectives, appoint its directors, provide its capital and assume ultimate risk in their investments. Given this, it is quite straightforward to accept that it is the shareholders to whom a company should be primarily accountable and they whose proprietorial interests should be primarily reflected in the business strategies adopted by directors.

The reforms made by the Companies Act 2006 do not disturb this position at all. Directors are still required to act in the best interests of their company and they owe this duty to their company alone (in effect to its body of shareholders). Directors are not made accountable to anyone other than their company’s shareholders and the reforms do not impose express obligations for them to act in any particular way in respect of any given cause or stakeholder group.

What the new Act has done, though, is to stress that what is in the best interests of a company or its shareholders is not something that can be defined exclusively by the expressed or perceived wishes of those shareholders: other factors, and the interests of other elements in society, also have a bearing on a company’s fortunes and those other interests must systematically be taken into account in steering the company forwards. Without laying down any standard expectation on the matter, the new Act also implies that directors will not be acting in the interests of their shareholders if they concentrate on short-term economic return at the expense of securing sustainable and longer-term success for the company. Thus the ‘enlightened shareholder value’ approach now enshrined in UK company law attempts to improve the quality of the board-level decision-making process by incorporating within it an expressly ‘inclusive’ approach.

DIRECTORS’ DUTY TO PROMOTE THE SUCCESS OF THE COMPANY

Before the new legislation was enacted, many argued that section 172 of the new Act, which sets out the mechanics of the directors’ basic duty to ‘promote the success’ of their company, was unnecessary. It would do nothing more, they argued, than articulate what was in practice the status quo, since any well-run board would be expected to act in the ways envisaged by the new section. (The assumption that all companies had adopted this holistic decision-making process was probably optimistic, even before the fall out from the financial crisis became apparent).

Under section 172, directors are required to act in ways that they consider are likely to promote the success of their company. This duty must be observed in all the decisions and actions that they take on behalf of their company. The courts will not interfere with directors’ judgements on such matters, either prospectively or retrospectively, provided they act in good faith. Directors remain entitled, therefore, to do what they think is right for their business.

Nonetheless, the difference now is that this freedom is not unrestrained. In order to comply with the basic duty, directors must ‘have regard’ to the specific matters listed in sub-sections (a) to (f) of section 172(1) (as well as to other factors that happen to be relevant to the matter in hand).

There are six specified factors in all:

- the likely consequences of any decision in the long term
- the interests of the company's employees
- the need to foster the company's business relationships with suppliers, customers and others
- the impact of the company's operations on the community and the environment
- the desirability of maintaining the company's reputation for high standards of business conduct
- the need to act fairly as between members of the company.

Breaches of directors' duty under section 172

Thus, while the law will not intervene in either the exercise of business judgement in decision making, or in respect of the relative weight applied by directors to the various specified factors, directors will not technically be in compliance with their basic duty under section 172 if they completely fail to 'have regard' to any or all of those factors (even if they otherwise act in good faith).

So, to take three of the factors set out above as examples, directors now risk being in breach in scenarios such as:

- where they make distributions of capital which, even if they satisfy the legal test of distributable profits at the time the decision to distribute is made, have the effect of rendering the company unable to meet cash flow demands that should have been anticipated and taken into account
- where they fail to take account of identifiable environmental risks associated with the company's operations, and fail to take reasonable precautions in respect of them, and as a result the company suffers civil and criminal penalties and/or reputational damage
- where they knowingly or negligently allow their company to become involved in criminal or 'unethical' acts that again cause loss or reputational damage to the company.

Thus, the key effect of section 172 is that where directors fail to take account of factors (the specified factors in particular) that have material implications for the interests of a company, and that failure results in some sort of loss to the company, they could be held to be in breach of their basic duty to promote the success of their company.

Whether directors will in practice be held liable for breach of duty will depend on whether they act in breach of the requirements outlined above and, crucially, on whether shareholders are sufficiently exercised by their directors' conduct to want to take action against them, that is, action extending beyond the options of selling their shares or voting against the directors' re-election. This is where the aim of strengthening the legal controls on directors' actions encounters the corporate governance challenge of achieving improvements in the area of active investment.

Enforcement of section 172

It has been argued that enforcement mechanisms for the new provisions are weak, and therefore likely to make little difference in practice to how companies behave, on two grounds. The first is that the Act requires directors only 'to have regard' to the specified factors (and other relevant matters). This is a very light touch requirement. On its own, it suggests that no substantial degree of time or attention is expected to be given as a matter of course. If a board is satisfied that any one or more of the given factors is immaterial or irrelevant to what they are doing, or if it considers that a decision it is minded to take is unaffected by any of the factors to which it is required to 'have regard', it will be entitled to do no more than come to that conclusion.

DIRECTORS' DUTY OF CARE, SKILL AND DILIGENCE

In exercising their functions, however, directors need to bear in mind another of the Act's provisions on directors' duties. Section 174 of the new Act requires them to exercise reasonable care, skill and diligence, qualities now defined by reference not solely to the particular background of the individual directors – the traditional, subjective test of skill and care – but also to the qualities that are to be expected of any person carrying out the duties of the director concerned – this is a new 'objective' test of skill and care. Thus there is now an objective benchmark of the skill, care and diligence with which the law expects every individual director to comply.

Accordingly, the law will expect directors, in the course of complying with the basic duty in section 172, to exercise reasonable skill and care in:

- identifying the factor or factors that will be particularly relevant to any given action or decision, and then
- paying an appropriate degree of attention to the relevant factor or factors.

Directors must therefore comply with the duty to promote the success of the company, in parallel with their duty of skill and care.

The second alleged weakness of the Act is that since directors owe their legal responsibilities only to their company, the law is powerless to ensure that companies respect, for example, ethical business standards, since no third party claiming to represent the interests of such standards is entitled to hold the directors to account.

Again, this is true: boards that maintain good relations with their shareholders are not likely to experience any pressure from the shareholders to uphold the interests represented by such standards.

SHAREHOLDERS' RIGHTS

In a gesture designed to give some teeth to the provisions on directors' duties, shareholders do now have the right to intervene through the courts if they think that directors are not living up to their legal responsibilities. Under section 261 of the new Act, any one or more shareholders may seek to commence legal proceedings against their company's directors, in the name of the company, for breach of their duties as directors.

It will not be easy for shareholders to do this. There are a number of conditions that they must satisfy if they are to be allowed to continue the claim against their directors in the courts: conditions designed to discourage frivolous actions or actions by 'single issue' shareholders. One of these tests is whether the shareholders' claim would be likely to have been brought by any director who was acting in accordance with the basic duty in section 172. In effect, the court will form a view as to whether the respondent director's behaviour was consistent with the duty to promote the success of the company, including the obligation to have regard to the factors considered above.

While enforcement of section 172 will be a matter for the shareholders and them alone, the cause of shareholder engagement in UK company affairs has been given significant backing in 2010 by the Walker review of corporate governance in banks and by the UK Stewardship Code, which has been issued by the Financial Reporting Council subsequent to Walker's recommendations. The new Code recommends that institutional investors play a more proactive and interventionist role in the affairs of the companies in which they invest. It calls on them to monitor their investee companies actively, to adopt clear guidelines on when and how they might improve their engagement with those companies, and to be prepared to act collectively with other investors where appropriate. Any remedial action considered by major investors is rarely likely to extend as far as pursuing directors for breach of duty but this will be an option for them and should not be totally discounted, especially if institutional investors consider that the interests of their own beneficial stakeholders have suffered as a result of directors' actions.

Even where shareholders show no interest in enforcing directors' duties under section 261, it should also be expected that the actions of directors, where they have caused loss to their company, will be reviewed at some future stage by a future liquidator, with a view to recovering monies owed to the company. Consideration of directors' conduct under other legislation, for example in respect of the corporate offence in the Bribery Act 2010, can also be expected to be undertaken by reference to the duties they have under the Companies Act.

THE CURRENT POSITION OF DIRECTORS

So where does this leave a company and its directors? Fundamentally, they remain entitled to commit their companies to the pursuit of profitable business ventures. Making money, and making profits, is after all what most businesses exist to do. If directors were not effective in these things their shareholders would probably consider that they were not serving their interests properly (in legal terms they might argue that the directors were not promoting the success of the company) and would probably respond by either voting to sack the directors or selling their investments. The reforms made by the Companies Act 2006 are not, therefore, intended to prevent company directors from taking risks in the pursuit of profit, and they do not in themselves penalise directors in cases where they get things wrong, in the sense that

they cause the company to lose money on projects or investments or to become insolvent.

If any significant change has occurred, it is a subtle one, though nonetheless one that is important for directors and all corporate stakeholders. While the law agrees that directors are entitled to take risks on behalf of their company, and are free to make judgements as to what courses of action are likely to be in their company's best interests, their freedom to do this is not unrestrained. They are now expected to act, and to make their decisions, in the light of a more structured assessment of how different factors and interests will affect those acts and decisions or be affected by them. While they are not steered to arrive at any particular conclusion as a result of this process, and are free to attach whatever weight they think appropriate to the different factors they consider, a complete failure to observe the due process will expose them to compliance risk and conceivably legal action initiated by their shareholders.

The main result of the UK reform, therefore, is that the identification and management of business risks is no longer (merely) something that well-run and responsible companies should be doing in their own material corporate interests: it has become an activity that also has legal status. As such, non-compliance with the new legal expectations has become a risk factor in itself. And if companies do not respond appropriately, the law has given investors the means to intervene. The ball is now in their court.

3. Making businesses more accountable to investors

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Forty years after Milton Friedman's seminal essay dismissing calls for the imposition of social responsibilities on business, corporate social responsibility (CSR) has, nonetheless, entered into the business mainstream. Despite the proliferation of corporate CSR departments and sustainability reports, however, it remains the case that for many companies, engaging with environmental and social risks is seen as an optional bolt-on largely focused on cost reduction and reputational benefits rather than as an essential component of effective risk management and strategic decision making. Meanwhile, events in the real world have made it clear that such risks may be highly material to corporate success and sustainability, deserving the attention of senior directors concerned with the core of corporate strategy.

The problem, as FairPensions sees it, is not so much a case that CSR is 'greenwash' but that companies are failing to appreciate fully the relevance of environmental, social and governance (ESG) issues to long-term performance. Institutional shareholders and the individuals on whose behalf they invest are suffering the financial consequences of this corporate failure. We do not seek to re-open the Friedman debate on whether companies have wider social responsibilities. Rather, the debate must move on to assess whether companies are focusing on identifying, reducing and managing those material risks to their businesses that arise from ESG issues. This chapter seeks to address why so many participants in the investment chain are still missing the point when it comes to the materiality of environmental and social issues to corporate performance and what regulatory and behavioural changes are necessary to ensure that CSR moves beyond employee volunteer programmes and philanthropic donations to being at the centre of effective corporate risk management and strategic decisions.

ESG ISSUES AS MATERIAL FINANCIAL RISKS

As an example of the consequences when companies inadequately assess ESG risks, one need look no further than the financial crisis and its roots in inadequate assessment of the risks of short-term business models, remuneration policies and provision of excessive credit. The year 2010 has seen further examples of the financial impacts of inadequate risk assessment and management. The fallout from the Deepwater Horizon fire and subsequent oil spill provides a stark warning for

corporations who fail to recognise environmental and social impacts as a necessary element of effective risk management. To date BP plc has incurred an estimated total charge of \$39.9 billion, seen its share price fall dramatically and suffered unprecedented damage to its brand in the United States of America. And yet BP plc, like many of the banks rescued by taxpayers across the world, has many of the policies and practices one associates with the now-accepted view of corporate CSR: it has a dedicated corporate social responsibility department, makes public statements on the importance of environmental matters and has a strong commitment to arts sponsorship in the UK. Despite this, the Gulf of Mexico disaster suggests a failure by BP plc to focus closely enough on social issues such as health and safety failings and environmental impacts and to incorporate these factors into senior-level decisions and practices.

BP's shareholders were not alone in suffering the consequences of failing to integrate social responsibility concerns into business decisions. On 23 August 2010, the London-listed Indian mining company, Vedanta Resources, saw its share price fall following a decision by the Indian government to reject its plans for a bauxite mine on environmental and social grounds (Responsible Investor 2010).

CHANGING CORPORATE BEHAVIOUR: THE ROLE OF INVESTORS

Unfortunately, it is unlikely that the occurrence of these recent events will be sufficient to ensure adequate consideration of ESG issues at a corporate board level without a corresponding change in investor behaviour. Investors ought to be the key players in ensuring that environmental and social matters that pose material risks for companies are placed at the centre of corporate decision-making practices. Apparently this is something that top company executives would like to see and regard as necessary for facilitating change at a corporate level. A recent survey carried out by the UNPRI and Accenture among international CEOs found that 86% of respondent CEOs want institutional investors to take a lead in ensuring that sustainability issues are more accurately priced into their investment decisions, to ensure that such issues are embedded at a corporate board level. Asset managers themselves admit that the short-term investment culture in which they operate is one barrier to integrating issues such as climate change more fully into investment decisions.

The need for institutional investors to exercise responsible ownership and extend their investment horizons is becoming an accepted part of mainstream discourse on investment. The financial crisis brought with it strong condemnation from some quarters of the role played by institutional investors. Described as acting like ‘absentee landlords’ by the then City Minister, Lord Myners, institutional investors faced calls to behave as owners rather than traders. The subsequent *Walker Review* (HM Treasury 2009) stated that ‘those who have significant rights of ownership and enjoy the very material advantage of limited liability should see these as complemented by a duty of stewardship’.

Following recommendations in the *Walker Review*, in July 2010 the Financial Reporting Council published the *UK Stewardship Code* for UK institutional investors aimed primarily at asset managers, with the intention of enhancing ‘the quality of engagement between institutional investors and companies’ (Financial Reporting Council 2010). Yet environmental and social issues have been strangely absent from the stewardship agenda. Despite the closer focus on governance issues, engagement on environmental and social issues is still regarded as an optional extra by many investors and their regulators. The *UK Stewardship Code* itself barely mentions engagement on environmental and social issues. The practical effect of this sidelining is significant. Shareholders’ willingness to exercise their influence in relation to strictly financial matters does appear to be on the rise – one recent example being the reversal by the Prudential board of takeover plans after public and private intervention by investors opposed to the plans. Yet there was a marked reluctance on the part of large UK institutional investors to support shareholder resolutions filed at BP and Shell in 2010 that focused on their highly contentious Canadian oil sands operations. If investors are to ensure effective integration of ESG issues at a corporate level, such issues must be an essential feature of their stewardship activities and it may be necessary for future versions of the *Stewardship Code* to make this explicit. In contrast to the *UK Stewardship Code*, the *Draft Code for Responsible Investing by Institutional Investors in South Africa* (Committee on Responsible Investing by Institutional Investors in South Africa 2010) makes explicit reference to the need for incorporating ESG issues into investment analysis and activities.

IMPROVED NARRATIVE REPORTING

If enlightened shareholder value is to be relied upon as a mechanism for ensuring that companies integrate ESG issues fully into strategic decision making, then company reporting requirements must ensure disclosure of all material risks: not least, material environmental and social risks. Only then will investors be able to integrate those risks into investment decisions and engagement activities in a meaningful way. More robust reporting requirements need not mean additional burdens on business. Indeed, the reverse may be true: one of the problems with social and environmental reporting at present is the proliferation of lengthy reports of little use to investors, in which key strategic issues are either masked, or ignored entirely.

As noted in a recent ACCA publication, reporting not only has the benefit of communicating information to shareholders and other stakeholders but ‘helps the preparers of the reports by focusing their minds’ (ACCA 2010). An improved reporting regime for social and environmental issues would lead both investors and companies to consider such issues in more detail. Poor standards of reporting raise concerns that actual risk-management practices mirror the deficiencies in narrative reports.

This is well-illustrated by the recent independent submission by Client Earth of Rio Tinto’s 2008 annual report to the Financial Reporting Review Panel (FRRP) (Client Earth 2008). In this case, the company makes general positive statements about the importance of environmental and social responsibility, but fails to mention numerous specific material issues with strategic implications, including the decision of a major shareholder to divest on environmental grounds, and the reputational and litigation risks associated with specific mining projects.

There is currently a lacuna in business reporting on environmental and social risks. Rather than integrating specific information on key ESG business risks into their depiction of the company’s business and strategy, many companies’ narrative reports make vague, boiler-plate statements to the effect that they take environmental and social issues seriously. All too often, environmental and social issues are instead consigned to backward-looking CSR or sustainability reports with detail provided on contributions to the local community and in-office environmental programmes. Such reporting can sometimes seem more like a public relations exercise than

a balanced overview of business risks, and presents an inappropriately positive view of the company. In our experience, information provided to investors in companies' narrative reports is inadequate to enable them to press directors on material environmental and social risks facing the business. By contrast companies' audited accounts generally allow investors to take a view on key financial risks. This is because audited accounts have characteristics such as comparability and verifiability, which we believe are now also necessary for reporting on environmental and social risks.

One of the greatest environmental risks facing companies is climate change. In FairPensions' 2009 survey of the practices of UK asset managers in relation to climate change, almost two-thirds of respondents cited poor-quality company data on greenhouse gas emissions as a barrier to greater integration of climate change risks into investment decisions. Most respondents (86%) said that they would welcome requirements on companies to report their emissions, while 78% would welcome stock exchange listing rules that required companies to disclose their climate-related risks.

In this context, the inclusion in the UK government's publication *The Coalition: Our Programme for Government* of a commitment to reintroduce an Operating and Financial Review is particularly welcome. It is hoped that a robust reporting framework emerges from this commitment that will enable investors to incorporate ESG issues more fully into investment activity and thereby drive integration of such issues into corporate decision making.

THE INVESTMENT CHAIN

If company CEOs are waiting to take their cue for action from institutional investors, then fund managers, in turn, are waiting for large clients to request the integration of environmental and social issues into investment decisions. In FairPensions' 2009 survey, 56% of respondent asset managers cited a lack of client demand as a barrier to managing climate change risks and opportunities (FairPensions 2009). Pension funds have an important role to play in ensuring that environmental and social issues are integrated into corporate decision making. In its implementation document on the *UK Stewardship Code*, the FRC highlights the importance of pension funds both specifically mandating asset managers to engage with companies on their behalf and carefully scrutinising their reports on engagement. Despite this, it is disappointing

that within the Code the FRC did not set out stewardship principles for asset owners such as pension funds, given their key role within the investment chain.

2010 marked the tenth anniversary of regulations requiring UK pension funds to disclose the extent (if any) to which environmental, social and ethical considerations are taken into account in making their investment decisions. Over this period, increasing numbers of occupational pension funds have included in their Statements of Investment Principles (SIPs) confirmation that ESG issues are taken into account to the extent that they are financially relevant, without providing any greater specificity. But is this broad policy commitment leading to concrete action to manage such risks? Recent research confirms that many UK pension funds are not taking steps to ensure that their asset managers adequately monitor ESG risks. FairPensions' most recent survey (FairPensions 2009) of large occupational pension schemes in the UK found that, despite universally acknowledging the importance of ESG issues in their SIPs:

- 35% of participating schemes did not integrate their ESG policy into investment management agreements with asset managers
- 30% did not, as part of the fund manager selection process, assess the ability of asset managers to manage ESG risks
- 35% did not require regular reporting from asset managers on what is being done to manage ESG risks.

So what, then, will secure further action from asset owners to drive environmental and social risk management through the investment chain right to the boardroom door? A key part of FairPensions' work is to educate and empower individual pension savers to ask questions of their pension providers and to make their preferences known with regard to the consideration of ESG issues in pension investment decisions. At the present time, individual pension savers are ill served by a regulatory system that allows a lack of transparency and accountability in the implementation by pension providers of the boilerplate policy statements referred to above. Greater transparency, achieved through requiring pension funds to report on how they have implemented their policy on ESG issues and their voting policy, would, we believe, lead to consumer scrutiny of, and demand for, engagement on ESG issues.

CONCLUSION

For too many companies consideration of ESG issues is limited to activities focused on operational cost reduction and reputation enhancement rather than the identification and management of material business risks. Recent events have highlighted the necessity for a change in these practices. Change will require action from all participants in the investment chain. Regulators must enable this action through initiatives such as the introduction of a robust operating and financial review that ensures the provision of forward-looking strategic disclosures on all material risks, including environmental and social risks. Institutional investors must scrutinise and use such disclosures to engage effectively with companies on ESG issues and demonstrate transparently to their asset-owner clients and ultimate beneficiaries that they are dealing with ESG risks. Environmental and social issues must be placed at the heart of investor stewardship by both investors and regulators. And the general public, whose savings are invested in companies, must become more engaged with their money managers and express their preferences for action on environmental and social issues. Greater accountability to the ultimate beneficiaries would be facilitated by the introduction of updated regulations requiring pension providers to report to pension savers on the integration of ESG decisions into investment decisions. Environmental and social issues must take their place at the heart of investor and corporate decision making so that companies, investors and individual savers will be in a better position to prevent or at least mitigate any future financially devastating events such as the banking crisis and the Gulf of Mexico oil spill.

4. Learning from environmental credit risk management

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The risk-management practices of the banking sector have been a focus of attention in evaluating both the causes and solutions to the recent financial crisis. With claims that the crisis was caused by an increase in sub-prime lending in the US property market – leading to write-downs of the banks' loan books, dramatic rises in lending interest rates and the eventual breakdown of interbank lending – the banks have been characterised by poor risk management, overreliance on property valuation, and a need for change. Nonetheless, there is an enduring positive trend within risk management in the banking sector that can give us cause for optimism – environmental credit risk management (ECRM) and, in particular, developments in climate risk management.

For a number of decades now, banks have engaged in ECRM to protect themselves from the material environmental risk primarily associated with commercial lending activities. Concern about environmental credit risk has been driven initially by potential lender liability associated with security ownership and a bank's controlling influence over a company to which it is lending. Arguably, if banks are perceived to exert such power as to influence a borrower's operational management then they should be held liable for the impact of the borrower on the environment and share clean-up responsibility. In practice, however, contamination may be historical and not the fault of the borrower or the bank. Thus, while banks have been careful to operate at arm's length from their borrowers, they have faced the challenge of relying upon real estate asset valuations while uncertain about the potential impact of environmental degradation of those sites. This is coupled with a bank's assessment and management of the risk to loan repayment that arises when a borrower's cash-generating ability is subject to a potential liability for clean-up costs and the prospect of shortfalls on asset valuations in the event of foreclosure.

ACCOUNTING AND THE CHALLENGES OF ENVIRONMENTAL RISKS

The accounting challenges posed by environmental risks are not necessarily all monetised or even quantifiable but they require 'recognition' and management. Delivering a presentation to an accounting and risk class at the University of Strathclyde in 2010, Chris Bray, head of environmental risk management with Barclays, elaborated on this challenge. His position is that the environmental risks that he manages are usually qualitative and not quantitative.

'There's not necessarily any linear scalability in the risk relationship, often there's no cap on some environmental liabilities – sometimes there may be but more often there's not, and the liability or reputational risk to a bank through association with clients showing poor environmental management can be disproportionate to the level of debt offered – it can be a real problem assessing the magnitude of risks of this nature.'

There is much that accountants can learn from the environmental valuation debate within environmental credit risk management over the last few decades, in particular with respect to the use value of financial and non-financial information.

CLIMATE CHANGE RISK

One of the criticisms of the financial sector during the financial crisis has been that banks have failed to consider systemic risk: in designing products and risk-management procedures they have not thought about the impact of their actions on the market as a whole. This is not the case with ECRM and climate risk. At the moment there are a number of initiatives in the market to raise the bar of ECRM across the global banking sector and ensure a minimum standard is operated for ECRM, so it is becoming more difficult for 'dirty' companies to shop around and find finance.

Take the example of the Equator Principles¹ for project finance. Banks have adopted internationally recognised environmental and social management standards by drawing on guidelines and indicators developed by the International Finance Corporation to provide a legitimate

1. A benchmark developed by the finance industry for determining, assessing and managing social and environmental risk in project financing.

model for risk assessment. Although commitment to the Equator Principles remains voluntary, few syndicates are led by non-Equator banks. When credit falls outside the scope of the Equator Principles there is an increasing expectation that Equator standards will influence general ECRM practice.

Efforts to raise lending standards across the banking sector are exemplified today by the mounting challenges of climate change. A briefing paper designed by Barclays, in collaboration with climate risk management specialists Acclimatise, highlights the potential material environmental risk (and opportunities) posed by changing weather patterns and associated physical impacts. The report *Credit Risk Impacts of a Changing Climate* (Bray et al. 2007) highlights current efforts within the banking sector to collaborate and encourage good practice. The target audiences in this instance are lenders and borrowers engaged in sectors dependent on substantial fixed assets and infrastructure, as well as the energy, chemicals, pharmaceuticals and tourism sectors. Advising on generic actions for climate-risk management, the report shares Barclays' experience of identifying climate sensitivities and critical thresholds for management in each sector. This includes advice on understanding and monitoring the position of external stakeholders, evaluating the supply chain, assets, operations and processes vulnerable to climate risk, and using mechanisms for managing financial risk, including insurance, to manage climate risk.

Arguably, what is restricting the development and standardisation of ECRM is the availability of appropriate information. In the light of suggestions that the next financial crisis may be based on climate risk we can expect these kinds of risk to proliferate in the future. The results of a global survey of the climate change information requirements of the financial sector, conducted by the Sustainable Business Institute with the United Nations Environment Programme Finance Initiative (2011), *Advancing Adaptation through Climate Information Services*, highlights this problem. The authors advise that: 'adapting to climate change boils down to identifying, quantifying, pricing, and mitigating the financial risks linked with

climate change impacts'. Integration of climate change information and assessment of environmental risks with financial information is needed to enhance financial interpretations and contribute to transparent asset and liability valuations. Accountants have a pivotal role to play in facilitating this change and ensuring finance is available for future economic growth and a movement beyond a low-carbon economy.

THE ROLE OF ACCOUNTANTS

The banks' reaction to environmental risk has depended on flexibility and creativity in order to come up with solutions. This illustrates that in the current financial crisis regulation and controls are not necessarily the solutions in every instance, at least until we have developed appropriate tools and standards to ensure clarity and adequate information is forthcoming that is suitable for purpose. From both a lender and a borrower perspective, a focus is needed on management systems and financial engagement involving accountants. In my experience we need a transparent, innovative solution to financing that highlights a shared perception of risk valuation, negotiated through stakeholder consultation and accounting expertise to ensure that information is available to help in making these investment decisions.

5. Avoiding bear-traps: an investor tool for identifying and managing business ethics risks

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INTRODUCTION

Stories of corruption, fraud or wider business ethics issues are rarely out of the news. Every year has its crop of unwelcome headline scandals, often implicating household corporate names or their staff in practices that damage reputations and send share prices plummeting. ‘Corruption’, that is ‘the abuse of entrusted power for private gain’ (Transparency International 2011), is a particular focus of UK companies in 2011 as the UK Bribery Act comes into force and the Serious Fraud Office (SFO) is talking publicly about the added resources it will bring to bear to prosecute UK and international companies that fall foul of the new law. Identifying and evaluating the risk that corruption or fraud will have a material impact on companies represents a real challenge for investors. At the extreme, such issues can have a catastrophic impact on share prices, as the failures at Enron, Worldcom and Parmalat demonstrate, and recent regulatory action and litigation in the US and Germany have resulted in fines in the hundreds of millions of dollars.

Collateral long-term damage to brand and competitive edge also extends beyond the core issues of fraud and corruption and into wider business ethics issues. In recent years, companies shown to have unscrupulous business practices, poor working conditions for employees or suppliers and/or poor environmental practices have found

that their broader reputation has suffered, undermining their share price in the short term and their ability to outperform their peers over the longer term by discouraging talented staff, customers and suppliers from working with the organisation. If anything, the response of financial markets to business ethics issues is likely to become more pronounced as governments around the world continue to reinforce sanctions on businesses that are found to have been guilty of poor ethical practices.

Box 5.1: Case study: Siemens

The corruption scandal at Siemens is perhaps the highest-profile corporate corruption scandal in recent years and a yardstick for the effect of business ethics problems on a modern business. The US cases against the company were settled in 2008 after the judge accepted guilty pleas from Siemens’ lawyers over a slush fund totalling more than €1.3billion that was used to win overseas contracts from 2001 to 2007. The scandal has cost Siemens, a symbol of German engineering excellence and corporate probity, not only its reputation and that of former senior executives but more than €3billion in fines and costs.

Table 5.1: Significant US and UK corporate corruption penalties in 2010

Year	Company	Industry	DOJ criminal penalties (millions)	SEC civil penalties (millions)	SFO settlements (millions)
2010	Technip and Snamprogetti	Construction and oil field services	\$240.0	\$125	–
2010	Daimler	Automotive	\$93.6	\$91 (disgorged profits)	–
2010	Innospec	Chemicals	\$41.1	\$11.2	\$12.7
2010	BAE Systems	Defense	\$400	N/A	£30

The problem facing investors is not so much a question of whether or not these issues matter, but how investors can both spot companies that are particularly vulnerable to unethical practices and adopt investment strategies that ensure that they are not negatively affected by those practices. Addressing this problem was the focus of a research project in 2009 undertaken by Henderson Global Investors and PwC. The project raised the following questions.

- How can one identify companies with a greater risk of unethical and/or illegal business practices and are there common risk characteristics and indicators?
- What reassurance should one look for in more vulnerable companies (ie what questions can one ask management about policies, systems, performance and practices)? What does 'good' business ethics risk-management practice look like?

While frameworks have been developed by investors and others that focus on assessing the quality of governance of business ethics and compliance, our objective was to go further and develop a framework for identifying both vulnerability to business ethics risks and the specific characteristics of best practices for managing these risks.

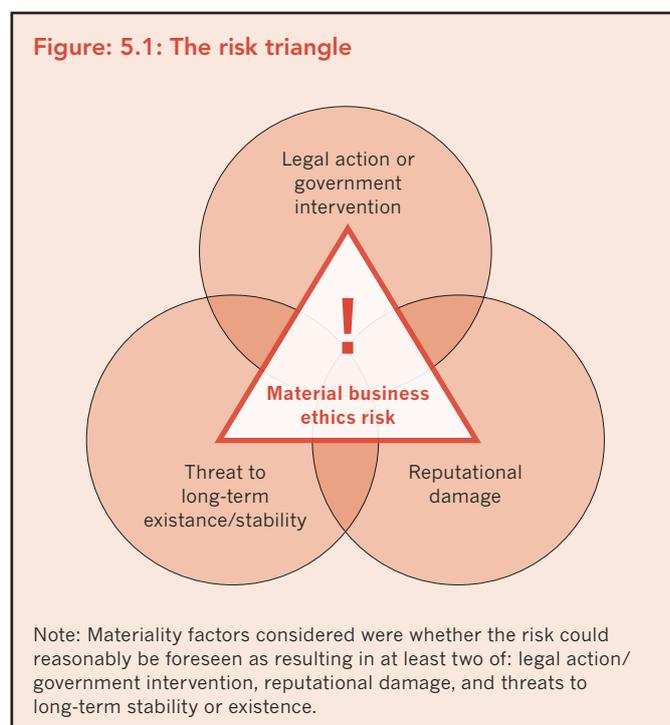
BUSINESS ETHICS AS AN INVESTMENT RISK

We regard business ethics as a form of applied ethics that relates to ethical principles and moral or ethical problems that arise in a business environment. For our purposes, in relating this back to a financial investment proposition, we were most interested in focusing on those unethical practices that are likely to have the largest impact on the share price performance of listed companies. This could be as a result of legal action or government intervention, reputational damage and/or another threat to the long-term existence or stability of the company. Although we recognise that there is a much wider business ethics agenda, we nonetheless defined the scope of business ethics for our purposes as relating to the broad issues defined in the Box 5.2.

Another key consideration for the project team was the potential materiality of the business ethics risk.

Materiality factors considered were whether the risk could reasonably be foreseen as resulting in at least two of:

- legal action or government intervention
- threat to long-term existence/stability
- reputational damage.



Box 5.2: Most common high-impact business-ethics risks and issues

Rogue trading/dealing/investment schemes: fraud that results from employees' actions that contravene industry and company rules and regulations, including Ponzi schemes, and from manipulating workplace controls.

Public sector corruption and bribery: where bribes are offered to government officials to win or retain business, or to achieve some other commercial advantage, eg obtaining licences and planning consents.

Bribery and corruption: the abuse of public office for private gain, including unilateral misconduct by government officials, such as embezzlement and nepotism.

Private sector corruption and bribery: the provision of improper benefit (in cash or kind) to customers, agents, contractors, suppliers and reciprocal benefits to employees or encouraging violating behaviour in subsidiaries.

Unscrupulous business practices: such as overcharging, marketing to socially disadvantaged or vulnerable customer groups and aggressive debt-collection methods.

Fraudulent borrowing or lending: such as putting intense pressure on companies seeking to extend credit lines.

Cartel fraud: collusion by firms or nations to attempt to control the price or supply of a commodity through mutual restraint on production.

Money laundering: the processes by which criminals attempt to conceal the true origin and ownership of the proceeds of criminal activities. Money-launderers will try to use legitimate businesses to 'clean' their funds.

Insider dealing: dealing or an attempt to deal, by an insider, in an investment on the basis of inside information in relation to the investment.

Market abuse: misusing information, creating a false or misleading impression, and/or distorting the market by manipulating prices.

Fraudulent misrepresentation: an instance of false statement, including omissions or disclosures intended to deceive, where the party making the statement is aware that it is false or disregards the possibility of its being false. It often involves collusion with third parties to misrepresent financial information and statements deliberately.

Environmental accountability: liability for remediation and operational compliance breaches from water pollution, land pollution and waste, air pollution and depletion of natural resources.

Social accountability: human rights abuses occur in almost all contexts and countries. Low-skilled and labour-intensive sectors pose the most acute risks, especially oil/gas, mining, infrastructure/construction, defence, pharmaceuticals/healthcare, tourism, forestry/agriculture, manufacturing/consumer supply chains (eg textiles and clothing).

IDENTIFYING 'RED-FLAG' RISK INDICATORS

The core of the framework focuses on a list of 'red flags', which relate to specific business characteristics that have historically been linked to a high incidence of material business ethics issues. Through an in-depth assessment of over 40 business ethics case studies we identified over 50 red flags, which were grouped into five broad categories:

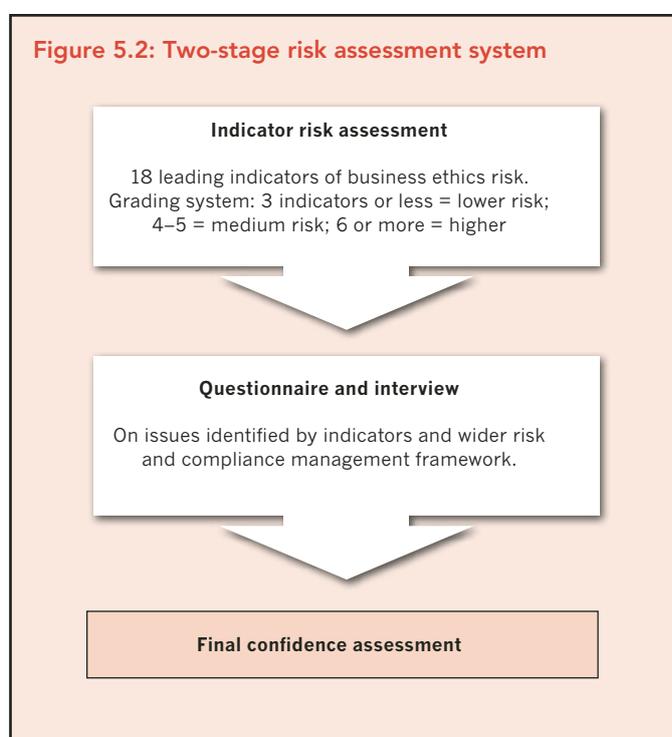
- type of industry
- country of operation
- company structure and business model
- management integrity and supervision
- high-level financial indicators.

In reviewing the case studies we also made the following observations.

- The number of indicators present for each case was significantly higher in cases that threatened the long-term viability of the company.
- There was overlap between some indicators, but it was the number of indicators present for each case that was of key importance, rather than the specific importance of particular indicators.
- Management integrity and supervision, and financial indicators were more important in catastrophic cases (those resulting in the destruction of the company).
- Limited availability of public information (eg financial data) made some indicators difficult to assess.

Ultimately, of the 50 red flags identified in the review of prior cases, we short-listed 18 that we considered to be measurable, objective and time-restricted. These red flags identify whether a business' characteristics and operating environment expose it to greater business ethics risk. In themselves, the red flags do not, however, mean that a particular company is necessarily more likely to be subject to business ethics malpractice, as it may manage those risks effectively. In order to determine whether any given company is indeed more likely to be subject to business ethics malpractice we therefore needed to engage directly with management to understand the quality of their

internal control systems for managing the vulnerabilities that we identified. This two-stage risk-assessment system is summarised in Figure 5.2 below.



Having developed the framework, we then pilot tested a 'live' portfolio of companies held in one of Henderson's UK funds. The portfolio was composed of over 100 companies but we narrowed the assessment to focus on the approximately 40 companies where the fund had an overweight position against the index. The 40 companies varied widely and were from a variety of industry sectors and sizes.

Of these 40 companies, 11 companies registered six or more red flags, 11 had between three and five and the remainder had fewer than three. From the companies that registered six or more red flags we selected five to engage with directly to obtain a better understanding of their internal control systems for managing the vulnerabilities we had identified. Table 5.2 summarises the key issues at the different companies and the 18 indicators we used to measure vulnerability to business ethics risks.

Figure 5.3: Portfolio companies with 'high' levels of vulnerability to business ethics risks													
Company	Type of Industry			Country of operation	Company structure and business model				Management integrity and supervision		High level financial indicators		
	Industry operates using large amounts of cash	Industry has high levels of government customers	Industry appears in the top five sectors on the Transparency International bribe payers index		Industry is 'on regulator's radar'	Greater than 30% of ops in countries with corruption perceptions index <3	Individual or group holds >15% of shares	Company's business model include large projects, tenders or long term contracts	Large-scale use of agents to win business	>3 material acquisitions (>5% of sales) or a large and complex acquisition / merger in last 3 years	Company has suffered financial or reputational damage from SEE* misconduct in the last 3 years.	Imbalance of power between exec and non-exec board and/ or dominant CEO	Company has had to restate accounts in last three years
Company A: heavy construction		x	x			x			x			x	
Company B: broadband retailer	x					x		x			x		x
Company C: medical equipment		x	x					x					
Company D: food products	x				x				x		x	x	
Company E: electrical components		x			x				x			x	x

* SEE = social, ethical or environmental

COMPANY ENGAGEMENT

The second stage of the process was to meet representatives of each of the companies that we had identified as being vulnerable to business ethics malpractice. We made clear in our communication with the companies that our risk assessment tool had simply identified them as being vulnerable, but that this was in no way intended to determine the existence or not of any malpractice. Of the five companies that we wrote to, four ultimately agreed to meet with us – the fifth released a statement soon after we wrote to them indicating that the management had uncovered an extensive financial fraud in one of the company's subsidiaries and would therefore not be able to discuss these issues separately with us.

The focus of the engagement was to explore the quality and depth of the control systems that each company had in place to manage the red-flag issues that we had uncovered. Although the project included only one meeting with each company, we were able to make several key preliminary findings from this process.

- The responsiveness of company management to our engagement was a strong indicator of the quality of the systems the company had in place (ie the more responsive the company, the higher the quality of the systems).
- Although most of the companies had clear policies in place to manage the relevant issues, there was a marked difference in the level of additional detail they were able to provide about the experiences they had had in implementing the policies.
- Similarly, some respondents were able to tell a compelling 'story' of risk management, while others described their experience as 'a journey' or had not grasped the importance of the issue.
- Overall, governance frameworks were a less valuable indicator, with most companies reporting senior-level leadership of key risk or the existence of ethics committees – though in only the most advanced companies was there a link to remuneration or other incentive structure.

- The quality and extent of reporting was also a key differentiator. For example, the more advanced companies were able to provide both detailed anecdotes as well as quantitative data on the performance of their internal control systems. In some cases companies were also reporting this publicly, through either their annual or corporate responsibility reports.

CONCLUSIONS

There is no doubt that changes in businesses' operating environment (eg regulatory change) are increasing risk in the area of business ethics to companies and therefore to investors. Indeed, a 2010 survey conducted by PwC on business ethics and 'Tone-from-the-Top' activity within companies, found that 70% of respondents agreed or strongly agreed that ethical risks are identified but only 34% report they are adequately measured or evaluated, while 27% confirmed that their business had recently terminated a business relationship as a response to unethical behaviour (PwC 2010). Though the tool developed did identify the one company of over 50 in the portfolio to suffer a serious business ethics issue last year, it is too early to comment on its overall effectiveness. While many of these 'risk indicators' themselves are unlikely to be new to portfolio managers, the value we have found is in incorporating them into a disciplined and structured framework to help assess business ethics risks. The framework can be applied at both portfolio level (but with significant resource requirement and existing knowledge for large numbers of stocks) and on a stock-by-stock analysis basis (eg for initial public offerings (IPOs), and new entrants to the portfolio).

The research on which this article is based was undertaken as part of Henderson's commitment to responsible investment practices and was supported by Henderson's Responsible Investment Committee.

6. Ethics: does ethical governance actually lead to better organisational performance?

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INTRODUCTION

Common sense might tell you that good ethical management will be reflected in strong organisational performance. In this chapter we explore whether ethical governance actually leads to better organisational performance, in particular whether or not we can establish a link at all.

There are many definitions for ethical governance, but it is generally accepted that it includes values such as integrity, fairness and respect, values that are driven by organisations through frameworks, rules and codes (ACCA 2010). For the purposes of this paper, I have situated ethical governance within the wider definition of governance: 'ensuring the organisation is doing the right things, in the right way, for the right people, in a timely, inclusive, open, honest and accountable manner' (Audit Commission 2009). This is because, like the Audit Commission (England), I believe that ethics are inseparable from governance as a whole. Therefore, I will be referring more widely to governance throughout this chapter.

DOES GOOD GOVERNANCE LEAD TO BETTER ORGANISATIONAL PERFORMANCE?

More often than not, organisations choose to make the link between governance and organisational performance whether or not there is any evidence to support it. It easily slides off the tongue, for example, 'good governance improves service performance' or 'strong governance leads to better quality services' (Bundred 2007). It is assumed that there is a direct and clear causal link between effective governance and the performance of an organisation in increased profitability, more effective service outcomes and improved reputation. In reality, however, the link to organisational performance is rarely strong. James Lockhart, a leading academic in this field, believes that after two decades of governance research '[w]e are little the wiser in determining whether or not there is some relationship between governance and the organisation's performance' (Lockhart 2006).

The correlation between effective governance and improved organisational performance has been explored in both the public and private sectors. Studies examining the links between changes in governance and performance, particularly relating to the public sector, are particularly scarce, and in some cases the evidence

appears questionable. Studies have examined whether there are links between different types of governance arrangements and organisational performance and have concluded that it is difficult to conclude that there are (Skelcher and Mathur 2004), and that, 'attempts to correlate board structures and performance were of little operational value' (Cadbury 2002).

In addition, a number of empirical studies have tested the link between reform of governance arrangements and changes or improvements in organisational performance. For example, Skelcher and Mathur tested the hypothesis that institutional economics-inspired theory, which has underpinned much recent public management reform, predicts improvements in organisational performance where an entity gains greater autonomy from politicians and greater engagement with market forces (Skelcher and Mathur 2004). The authors conclude that the theoretical connections between governance arrangements and organisational performance are poorly supported by the evidence. In fact, at the time of their research it was easier to establish the implications of governance arrangements for democratic performance than for organisational performance. Also, Jobome suggests that good governance does not necessarily imply higher performance – private sector-style governance arrangements do not always predicate high performance (Jobome 2006).

Overall, the literature shows that it is easier to make the link between governance and public trust and confidence. Rowson (2006), for instance, discusses how an ethical framework can enable professionals to work more effectively, earn trust, mutual support and respect, and foster democratic ideals. He argues that despite differences between professionals, there are certain common core values that, if accepted and acknowledged by every profession, could help each be more effective and could also enhance cooperation between them.

The authors of an Audit Commission report (2003), *Corporate Governance: Improvement and Trust in Local Public Services*, also note that although there is evidence to suggest that inappropriate behaviour can damage public confidence, the link between performance and ethical behaviour is less clear: 'High performing councils – as measured through Comprehensive Performance Assessment (CPA) – can display poor ethical standards, and that some poorly performing councils have high ethical standards' (Audit Commission 2003).

Nonetheless, it has been demonstrated that certain aspects of governance can be associated with greater efficiency. For example, government funding (external governance) is associated with high pass-through efficiency because of the effectiveness of the reporting and monitoring mechanisms that accompany such funding. It was concluded from research by the Audit Commission (2003) that efficiency benefits can be gained from use of 'internal or external devices which strengthen reporting mechanisms and restrict managerial discretion'.

An extensive worldwide survey carried out by McKinsey and Company (2002) found compelling evidence to suggest that investors will pay a premium for companies with high governance standards. Premiums averaged between 20% and 35% in Asian countries. This is an indication that well-governed organisations will perform better in the stock market. In addition, in a study of more than 5,200 firms in the US, Aggarwal (2007) looked at 64 governance attributes and found a positive and statistically significant relationship between governance and firm value.

POOR GOVERNANCE IS MORE EASILY LINKED TO ORGANISATIONAL FAILURES

Nonetheless, it is perhaps easier to turn the debate on the impact of governance on its head by making the link between ineffective organisational performance and governance. This would seem appropriate because of the catalogue of organisational failures and evidence to draw upon. I strongly believe that at the heart of every organisational failure is poor governance and ethical behaviour. High-profile corporate failures underpinned by poor ethical standards of behaviour and/or sleaze have brought ethical governance into sharp focus in both the private and public sectors. Larry Scanlan, President and COO of the Hunter Group (US), summed this up succinctly: 'I've never seen a distressed organisation that could not be traced back to ineffective governance' (Scanlan 2010).

Most recently, serious flaws and shortcomings in governance have been identified with the banks. The non-executive oversight of bank executives fell short and has brought governance issues back in the public eye (House of Commons Treasury Committee 2009). Prior to this there was a wave of scandals, including Enron and Maxwell. In the public sector there have also been a number of high-profile service failures.

In the public sector, failures in service performance have often resulted from failures in governance. For example, in July 2006 the Audit Commission reported that weaknesses in governance had been a key factor in the financial meltdown of a number of NHS trusts (Audit Commission 2006). A recent report into the governance of Doncaster Metropolitan Borough revealed that over a period of 15 years there had been a spate of instances of poor ethical behaviour that had resulted in poor service outcomes for citizens: 'The Council, and key councillors within it, are not working constructively with the Mayor or with partners to achieve better outcomes for the people of Doncaster. Some influential councillors place their antagonism towards the Mayor and Mayoral system, and the achievements of their political objectives, above the needs of the people of Doncaster, and their duty to lead the continuous improvement of services' (Audit Commission 2010).

The adoption of a performance culture in public services has led in some cases to unintended governance consequences. The pressure to hit targets has led to 'fiddling figures, phantom placement scams and double counting in the case of meeting employment targets' (Lawton 1998). In local government there was the example of postal vote irregularities by councillors prior to two local council elections in Birmingham. Fawcett and Wardman also have also drawn attention to the Bristol Royal Infirmary Inquiry (2001) and the Climblíé Inquiry (2003) as revealing further examples of poor governance (Fawcett and Wardman 2008). In all these cases it is all too easy to identify the factors and failures that contribute to failure after the event.

GOING FORWARD

So where do we go from here? There is substantial evidence to suggest that governance can affect public trust and accountability. It would appear to be common sense that good governance is linked to effective performance: if demonstrable links to poor performance can be made then there is surely a case for making a link. In the higher education sector, for example, Bader (2001) identifies four tangible ways in which governing bodies can add value in the non-corporate sectors and so improve performance:

- making better high-level decisions and asking questions about proposed strategic business and financial transactions
- achieving better organisational performance by setting ambitious but realistic goals and monitoring performance
- making critical connections by discussing how well programmes and priorities reflect the needs of key constituents through their work, from approving the strategic plan to monitoring programme performance
- being conscious of mission and values so that these are expressed and advanced in the entire organisation's work and in the goals set for the organisation.

Nonetheless, the Audit Commission (England) would argue that this relationship is less precise, given its findings that both well-performing and poor-performing local authorities are equally likely to exhibit poor ethical behaviours. Equally, other sectors struggle to demonstrate what 'added value' a governing board brings to the performance of an organisation. Some studies in the public sector have suggested relationships between some aspects of governance and service quality, but when digging deeper research has shown that governance alone does not account for everything that determines service quality and improvements in the public sector (Audit Commission 2003).

CONCLUSION

To conclude, while it is (relatively) easy to find associations between certain governance arrangements and performance, it is more difficult to establish whether the governance arrangement is responsible for that performance, or whether other variables are more important. The evidence seems to suggest that there are too many internal and external factors to take into account to establish a causal link: too many factors that are arguably not measurable, eg the ethical culture of an organisation and time lags between when an organisation's board acts/makes a decision and when performance responds. Ultimately, this makes it difficult to find evidence to support a causal link between performance and governance.

I strongly believe further research is necessary in this area if we are to gain a better understanding of how governance affects improvements in organisational performance. We need to understand, for example, how and at what stage poor ethical performance affects the performance of organisations and the length of time for which organisations can maintain performance with poor ethical governance.

7. Ethical leadership: lessons from two biographies

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In 1893, a young 24-year old Indian lawyer is thrown violently off the train to Pretoria at Maritzburg station. He has a first-class ticket, but only whites are allowed to travel first class, and he refuses to move to a third-class wagon. In the cold of the winter night, he reflects on what he should do: to fight and seek personal revenge? He considers that his own hardship is superficial and only a symptom of the deep disease of colour prejudice. This, and not his own bitterness, is the evil that needs to be overcome.

In 1914, a young 26-year old cognac merchant travels back from London to his native France. An article he is reading in the train shocks him: the UK and France are allies in the First World War (as it would come to be known), but their fleets carry out unhealthy competition over the seas, which causes prices to rocket for both civilians and the armies. He manages to speak to the French Prime Minister about this problem and the latter sends the young man to London as the French representative in charge of coordinating Allied economic cooperation (Roussel 1996).

The Maritzburg incident is considered to be the defining moment in Gandhi's life as social activist (Flucker 2009). The problem of supply coordination in times of war was the first one in a series that Jean Monnet, the architect of the European integration process, saw and solved as a sui generis civil servant.

Both men exerted a huge influence on public affairs in their native countries and worldwide. Never elected to public office, they inspired by their actions. What ethical leadership lessons can we draw from the biographies of two twentieth-century leaders?

ETHICAL LEADERSHIP, A CHOICE

First, Gandhi and Monnet became leaders: nothing predestined a lawyer and a businessman to become the change agents they eventually were, not on this scale at least.²

At the origin of their journey to leadership there was a choice: to complain – the most human attitude when faced with a problem or any form of injustice – or to act. Both Gandhi and Monnet decided to act: Gandhi chose to overcome his personal frustration and became a social rights activist by embracing the cause of all Indians. Monnet dared to share his concerns and to stand, young man as he was, in front of his Prime Minister, proposing a solution and ending up being called upon to implement it. It is, in my view, a fundamental choice in everyone's life and, in particular, in difficult times: do I see myself as a victim and act accordingly or do I take the lead and decide to act and do what I can, here and now, within my sphere of influence?

in this fundamental choice for leadership I see two common traits possessed by both Monnet and Gandhi.

First, their original choices lasted their entire lifetimes and were followed by a series of other consistent choices. Gandhi could have allowed violence in the Indian liberation movement, but chose to pursue non-violence as a means and as an end for his action; Monnet chose to continue to address various major problems one by one, and by doing so contributed, among other things, to the victory of the Allies in the Second World War (Rieben 1996)³ and to making another world war materially impossible. He did so by creating a shared sovereignty of the resources that had been at the origin of the two global conflicts, coal and steel, which was the first step in the European integration process in the early 1950s.

2. As a matter of fact, Gandhi was born into a family of three generations of local prime ministers. None of his ancestors, however, exerted an influence beyond their constituency.

3. The action of Jean Monnet during the Second World War was considered by John Maynard Keynes to have shortened the war by one year.

ETHICAL LEADERSHIP HAS TO DO WITH AUTHORITY, NOT WITH POWER

Secondly, Gandhi and Monnet did not wait until they became prime minister – and in fact neither ever did – to decide to take the lead: they both acted from where they were, as human beings first and foremost. They never took up an elected public office, yet continued to exert a considerable influence throughout their entire lives.

We often see leadership connected to management positions; we tend to consider leaders as those at the top of an organisation. And they are, insofar as they have the power to dictate what people in the organisation are to do or not to do, and the possibility of punishing them if they do not comply. Yet, it was not this form of power that Gandhi and Monnet had at their disposal: they led through authority, which means influencing people to act a certain way, without being able to force them.⁴

The considerable influence that Gandhi and Monnet were able to exert derived from their moral fibre rather than from their position; from what they were rather than from where they were. De Gaulle nicknamed Monnet ‘the inspirer’, which reflected what he truly was: a man at the origin of change, capable of creating the conditions for change to happen and of inspiring recognition in others of the necessity of change. Indeed, Monnet’s method consisted of concentrating on the single most important problem to be addressed in a given moment, finding a solution and ‘selling it’ to the politicians who had the power to implement it. At this point, Monnet’s task was over and he let the politicians take the responsibility and the recognition for his ideas and solutions.

Monnet and Gandhi led by example, which, for the latter, meant a great deal of personal suffering and sacrifice, being imprisoned for a total of more than ten years and physically beaten many times.

ETHICAL LEADERS ARE SOCIAL INNOVATORS

Exerting leadership from anywhere else than from the top challenges the control and command paradigm, ie leadership through power, which is effective for delivering ‘more of the same’, and is most suitable when things go well. In times of trouble, however, when new solutions are needed, power alone shows its limits: new roads and progress are made possible only by influencing through authority, which calls for creativity and new paradigms.

By not seeking power, Gandhi and Monnet expanded their sphere of influence beyond what could have been imagined before. Throughout their lifetimes, they maintained the freedom to look at what was possible, since they did not need to worry about keeping power that they did not have.

They created a community of activists around them who embraced their cause and made change possible: the ashrams and villages that played a huge role in the independence of India; the think-tanks and the courageous politicians who were instrumental in elaborating and implementing Monnet’s ideas.

They practised methods that proved successful beyond the circumstances in which these leaders had conceived them: fighting for freedom through non-violence worked when applied by Martin Luther King Jr and Nelson Mandela; sharing the resources instead of combating for them is seen as a possible way out of the Israeli–Palestinian conflict.

4. The concepts of power and authority, and their differences, were developed by Max Weber (1947).

INTEGRITY AS A WHOLE

Gandhi and Monnet not only led by example and personal integrity in the traditional meaning of 'walking the talk': do what one says and say what one does; they also practised integrity in its etymological sense, from the Latin *integritas*, wholeness.

They were capable of looking beyond particular interests, looking at the whole picture. Gandhi considered his actions towards Indian independence as a contribution to solving the entire world's, not only India's, problems (Kumar 2007). Monnet saw the cooperation he was setting in motion among European countries and peoples as a blueprint for the possible organisation of tomorrow's world (Monnet 1976).

They were able to have the whole picture in mind because they had developed what Covey (1992) calls 'abundance mentality': life is not a cake, to be cut up into a limited number of slices, whereby if someone takes a bigger slice, it diminishes my share. For them, wealth and opportunities can be created to virtually an unlimited extent.

Monnet's and Gandhi's win-win attitude was rooted in the abundance mentality: struggling for a free India did not prevent Gandhi from supporting the British in the war effort in the Zulu conflict in South Africa and during the First World War; the French Monnet was equally eager to serve the French interest in the UK during the First World War, to represent the British under the American administration during the Second World War, and to strive for common interest his entire life.

PERSONAL CREDIBILITY

Monnet and Gandhi were consistently able to put common interest above their own: this resulted in the capacity to give and obtain trust. One of Monnet's close collaborators gave evidence that Monnet's vast influence derived from the fact that he never asked for anything for himself (Roussel). Gandhi was capable of a huge amount of personal sacrifice, including accepting the risk of death in many of his hunger strikes, to pursue common good.

They were masters in creating relationships rooted in trust, and in generating trustworthy activists around them with the same moral fibre. They proved with their examples that leadership is above all managing relationships, not things. The huge changes they set in motion were made possible only by investing time and energy in creating and nurturing trustworthy relationships.

They were also aware of the importance of the relationship with themselves: Monnet and Gandhi shared the habit of taking long walks alone, as a means of keeping in good physical shape and to distance themselves from action before making an important decision.

A LASTING HERITAGE

To summarise, ethical leadership, as it emerges from the lives of Gandhi and Monnet, is less linked to a role than it is rooted in a choice, a call to answer a problem they saw and that probably nobody else saw at that time in the same compelling way. This call brought them to act, as citizens first and foremost, in the public arena; having not only personal integrity and trustworthiness but the whole picture in mind, the larger context in which their concrete actions were taking place, they became social innovators and inspired many around them to act, which in turn made the change they aimed at possible.

Ethical leaders such as Monnet and Gandhi continue to inspire decades after their death. They have left behind a lasting heritage of lessons in leadership that can be synthesised by Gandhi's famous motto: 'The difference between what we do and what we are capable of doing would suffice to solve most of the world's problems'.

8. Measuring ethical performance

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Ethical performance is of significant interest within the public sector, and two recent political developments demonstrate the difficulties that surround its measurement. The creation of the Independent Parliamentary Standards Authority, in the wake of the Parliamentary expenses scandal, has already met with significant criticisms from MPs for being overly bureaucratic and personally invasive. Conversely, in local government, the Localism Bill promised to 'abolish the Standards Board regime', including Standards for England, the strategic regulator tasked with overseeing investigations into breaches of the local government code of conduct. The differing fortunes of these regulatory agencies highlight a number of key problems surrounding the measurement of ethical performance. First, what exactly is to be measured? Is poor performance regarded as that of individuals (the 'bad apples' argument) or that of organisations and institutions themselves? Second, how closely is ethical performance to be linked to organisational culture and the effects of leadership? Perhaps most fundamentally, what exactly is being measured in such a grey area as ethics, and are results themselves open to different interpretations? This chapter will briefly address these questions, before describing two models of ethical performance measurement: the ethical climate model; and the ethical audit toolkit. It will then look at some of the practical issues in conducting ethical performance measurement.

WHAT CAN BE MEASURED?

Organisational ethics are often discussed in terms of a spectrum between compliance and integrity (for example, Skelcher and Snape 2001; Lawton and Macaulay 2004; Lewis and Gilman 2005; Menzel 2007). Organisations that favour a compliance approach focus on formalised rules; whereas organisations that promote an integrity perspective are more character-orientated and seek to develop public managers' moral sense, particularly through ethical leadership (Cooper 2001). Ethical performance measures need to take into account all these perspectives, and can therefore address a number of different levels.

Compliance mechanisms

At the most basic level, performance can be measured by how well an organisation meets (or exceeds) standard compliance requirements, eg a code of conduct; protocols; protection for whistle-blowers. Difficulties with using this approach are that the existence of such mechanisms does

not ensure adherence to them: Enron (in) famously had significant compliance mechanisms in place (Jennings 2006). A further issue, which is particularly prevalent in the current UK public sector, is that when working in partnership with private or third-sector organisations, such compliance mechanisms can be qualitatively different and therefore careful attention needs to be paid to partnership arrangements.

Organisational processes

Another potentially crucial factor is the way in which the organisation conducts itself, and thus processes may be another aspect of ethical performance measurement: transparency of decision making; fairness of disciplinary procedures; accountability of management decisions; consistency of processes; etc. Although such measures represent a further step up from simple compliance, there is still a need to establish an initial standard. One's perspective of the fairness of a disciplinary hearing, for example, may differ radically depending on whether or not one is conducting the hearing, or is at the receiving end of it. Such factors can be addressed at the very outset of the measurement process.

Outcomes

Another level of measurement will involve outcomes, an approach that was favoured, for example, by organisations such as Standards for England: number of complaints received; percentage of cases investigated or rejected; number of complaints upheld, etc. One difficulty here is that often there are outcomes that prove notoriously difficult to measure, eg public trust, which has always been extremely low in politicians both centrally and locally (Macaulay and Lawton 2006). It remains to be seen whether or not recent developments in Parliament will increase levels of public trust in MPs. A further, and possibly even more complex problem, is that outcome measures can be open to various interpretations. Complaints against the local government code of conduct in England, Scotland and Wales all remain comparatively low (Macaulay et al. 2010) yet this could be seen as a failure (that there is no need to invest in a standards framework when so few cases arise) or as a success (that the standards framework is keeping the numbers of complaints low). The standard of measurement for outcomes is therefore often outside organisational hands, and resides in the public, media or politicians. In such cases communication is as important as ethical performance itself.

Behaviours

Perhaps the most crucial (and certainly the most complex) standard of all is individual behaviour. Are staff treated with respect? Is there a culture of bullying? Previous studies have indicated that the role of behaviours is so important that ethical performance is intrinsically linked to Human Resources (HR) performance (Lawton et al. 2005). The reason for such complexity is that there is a distinction between action and intent. Unethical actions may occur through ignorance or incompetence rather than malicious intent but they would nevertheless be captured in ethical performance measures. For this reason it is crucial that qualitative data are captured by the measurement regime and used to inform constructive organisational feedback.

There are, of course, other ways to distinguish ethical performance. In many European studies, for example, an increasingly popular way of categorising performance has been the development of measures of integrity violations (Huberts et al. 2006):

- bribery
- nepotism and cronyism
- fraud and theft
- conflict of interest
- improper use of authority
- misuse of information
- discrimination and harassment
- waste of resources, and
- private misconduct.

Again, however, these categories are by no means clear cut. Although instances of bribery may be relatively easy to identify and, more importantly, have a fairly commonly accepted understanding of what the act entails, examples of private misconduct or the improper use of authority are potentially much less tangible.

HOW CAN ETHICAL PERFORMANCE BE MEASURED?

Measuring ethical performance has popularly become known as ethical audit (Bouckeart and Halligan 2008; Lawton et al. 2010). For all of the reasons outlined in the previous section, an ethical audit must necessarily be more flexible and less rigid than other audit regimes. It looks at the overall ethical health of an organisation, which can be defined narrowly (as compliance) or more broadly (as integrity). There are several tools for conducting an ethical audit and two popular approaches will be outlined shortly. First, it may be useful to look at the general processes involved. Lawton et al. (2010) suggest that there are four stages to measuring ethical performance: planning, fieldwork, reporting, and follow-up (see Figure 8.1).



Stage 1: Planning

As previously noted, different ethical frameworks affect very different groups of people. Good planning is therefore essential for creating a standardised procedure, which can be applied to the relevant organisation. There are at least four steps to the planning process (Lawton et al. 2010).

1. Notification – all relevant stakeholders must be told that an ethical audit is to be conducted.
2. A pre-audit meeting must be held to discuss the nature and scope of the audit. At this stage a number of key questions may be addressed.
 - What systems or procedures are in place in authorities to regulate and/or promote ethical conduct?
 - What are the key components of an ethical environment that would help change attitudes/cultures?

- How aware are members of the ethical environment?
 - How aware are officers of the ethical environment?
 - How do the ‘hard’ factors of systems and processes affect member behaviour? How influential are they on member behaviour?
 - Who are the key players in an authority in determining the ethical environment?
 - How important are the roles of the chief executive and the leader in promoting and maintaining an ethical environment? What roles/activities should they undertake?
3. All relevant, pre-existing documentation that relates to the organisation being audited (eg codes of conduct, legislation, etc) must be collected.
 4. A preliminary risk assessment is necessary. Large organisations such as local authorities necessarily carry out an enormous array of activities. These may not all carry the same ethical risk and therefore some key areas may need to be identified (eg procurement, senior management appointments, financial administration).

Stage 2: Fieldwork

The fieldwork stage of the ethical audit will be directly contingent upon the scope of the performance measurement as identified in the planning stage. There are a number of tools available, and below two different models that have been popularised in recent decades are outlined: the ethical governance toolkit and the ethical climate framework. The key consideration is one of appropriateness; matching the methodology to the key performance measures. Recent studies in Australia and New Zealand, for example, have argued for the importance of self-perception surveys to capture perspectives on organisational processes and individual behaviours. Other important methods may be more qualitative – interviews, focus groups, or even observations – to assess the reality and deeper meaning behind questionnaire responses. The use of qualitative methods in all sorts of evaluation studies has come increasingly to the fore in recent years (see, for example, Wond and Macaulay 2010).

Stage 3: Reporting

The audit report will address two key areas: first, it should identify key ethical risks and secondly, it should provide recommendations for minimising these risks (Lawton et al. 2010). In so doing the report will show fundamental issues that already exist as well as potential issues that may arise in the future. Recommendations can thus be prioritised. It is useful to divide the reporting process itself into a number of stages: the initial report that is presented to the organisation; an organisational response, which will include a register of priorities and an action plan; and then a final report, which will incorporate this response and provide timescales and milestones for future performance.

Stage 4: Follow-up

Depending on what is in the final ethical audit report, a number of follow-up tasks could be identified and developed: for example, a review and update of compliance mechanisms, or new training for members of the organisation. Another key follow-up task will be a re-evaluation within an agreed time frame. To try and flesh out the ethical audit process it may be worthwhile to look at two specific models that have been developed in recent years.

THE ETHICAL GOVERNANCE TOOLKIT

The ethical governance toolkit was developed by the Audit Commission, Standards for England and Local Government Improvement and Development (formerly the IDeA). It is the model that has been primarily used by local authorities and is described as ‘a simple yet effective tool for evaluating strengths and weaknesses, and then adjusting rules, processes and practices accordingly’ (IDeA 2010).

The ethical governance toolkit is used to promote ethical governance along four lines:

- ensuring that new council arrangements are open, accountable and ethically strong
- promoting high standards of conduct
- assisting in building a ‘bond of trust’ between councils and communities
- identifying best practice for sharing and dissemination.

The toolkit can be used to promote the corporate values (implicit and explicit) of any local authority, and to test whether or not there are any gaps between official and actual values, which can also be tested against core ethical competences: integrity, accountability and standards management. Therefore the toolkit is divided into two stages: diagnosis and development.

The diagnostic questionnaire tests knowledge and understanding of approximately 150 different items relevant to the ethical health of a local authority and is directed towards politicians and chief officers. It can check awareness and the usefulness of an authority's accountability mechanisms, eg whistle-blowing protocol, register of interests, codes of conduct (for members and staff), Monitoring Officer protocol. Typical questions could be:

- Are you aware of the whistle-blowing protocol? (yes/no)
- Have you ever used the whistle-blowing protocol? (yes/no)
- Would you use the whistle-blowing protocol if necessary? (yes/no)

The diagnostic survey can also test perception of processes, outcomes and more general areas such as leadership, for example:

- My authority acts ethically at all times (answer on a scale of 1 to 5).
- I act ethically at all times (answer on a scale of 1 to 5).

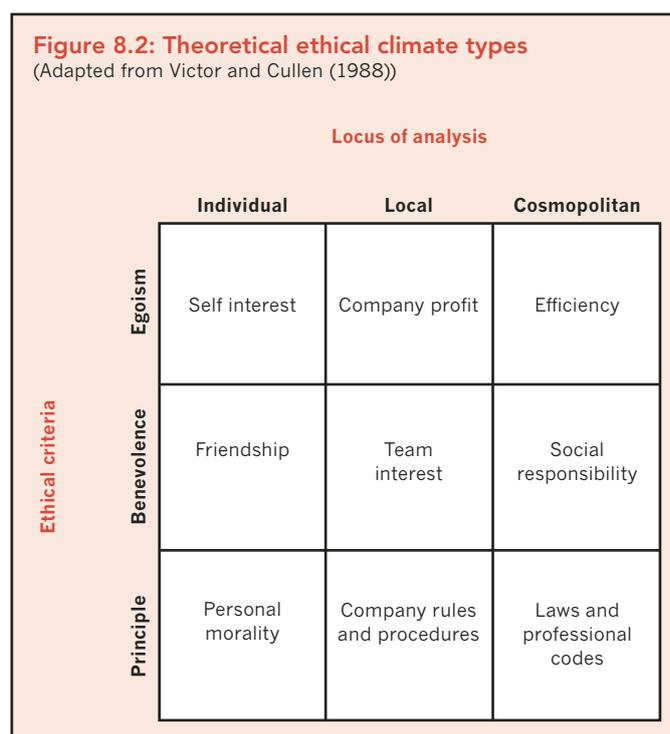
The benefit of this model is that it is relatively quick and easy to implement. It gives standard data for staff and members at all levels, which can be readily analysed and comparisons can be made between different local authorities. The toolkit may not necessarily encourage candour, however, and even under the cloak of anonymity many respondents may feel obliged to paint a more positive picture of the authority's and particularly their own behaviour. Perhaps more importantly, an authority can score highly on knowledge and understanding, yet may still be susceptible to behavioural issues such as discrimination or bullying. Even taking into account the interview stage, the actual nature of what ethics means to different individuals or groups is not fully addressed by this model and as a result it may not reveal how ethical an authority actually is.

THE ETHICAL CLIMATE FRAMEWORK

The ethical climate framework was pioneered by Victor and Cullen (1988) and presents an arguably more sophisticated view of what constitutes ethical behaviour and ethical governance. It has been applied regularly in private sector organisations and has been tested and amended on numerous occasions (Wimbush et al. 1997a; Wimbush et al. 1997b; Peterson 2002) but its principles remain basically the same. Victor and Cullen (1988) identify nine possible ethical climates within organisations, which are outlined in Figure 8.2.

The **ethical criteria** refers to the criteria that people use in making individual ethical decisions: whether or not to follow rules, decisions to pursue the public or private interest, etc. The **locus of analysis** refers to the sources of an individual's ethical values, whether work groups, professional bodies or outside or partner bodies. Together these form a matrix of ethical behaviours that can subsequently be tested.

The ethical climate also entails other dimensions – caring, rules, independence, etc – in which ethical behaviour can



be situated. These can be tested via a questionnaire, which will include questions such as:

- In this company people are expected to follow their own personal and moral beliefs (agree or disagree, five-point scale).
- Successful people in this organisation go by the book (agree or disagree, five-point scale).
- In this organisation, people look out for each other's good (agree or disagree, five-point scale).

The major benefit to this model is that through questions such as those above, underlying ethical attitudes and perceptions can be measured without recourse to asking direct questions about ethical behaviour. One potential drawback is that the model is complex and will require considerable planning before it can be implemented.

LEADERSHIP AND PERFORMANCE

One crucial question remains: what is the role of leaders in the ethical performance of an organisation? Leadership is often seen as an inherently ethical task: 'morality magnified' in the words of Joanna Ciulla (2006: 17) and the ethical expectations on leaders are frequently higher than on others (Ciulla 2001). Ethical leadership inspires high ethical performance: it provides legitimacy and credibility for the values and vision of an organisation (Mendonca 2001). It also helps to create trust, which is particularly significant during periods of change and uncertainty, when members of organisations can become demotivated or even suspicious (Thomas et al. 2004). In the current political climate, in which a new government seeks to make sweeping changes, such leadership may be seen as even more significant.

Ethical leadership is considered such a cornerstone of organisational performance that various instruments have been developed for measuring its impact. Bass and Steidlmeier (1999), for example, have created the authentic and pseudo-transformational leadership scales. The former demonstrates genuine outward-facing concern for the needs and good of the organisation (public or private), whereas the latter is geared toward self-interest (glory, personal power, individual financial reward, etc). They argue that authentic leadership ignores the self and is oriented towards the development of followers and the needs of the organisation.

Similarly, the Perceived Leadership Integrity Scale (PLIS) (Parry and Proctor-Thomson 2002), measures the relationship between individual perceptions of a leader's behaviour with the perceived effectiveness of his or her leadership style. The PLIS provides correlations between perceived levels of integrity and commitment to the leadership, which underlines the view that 'a good leader is an ethical and effective leader' (Ciulla 2001).

What, then, does an ethical leader do that other leaders do not? Trevino et al. (2003) identify seven characteristics. The ethical leader:

1. maintains an outward-oriented people focus that seeks to develop followers
2. exhibits highly-visible good conduct
3. is an open communicator with good listening skills
4. sets high standards for themselves and others while not tolerating lapses in conduct
5. has strong sense of accountability
6. highlights the decision-making process as an end in itself
7. demonstrates a broad understanding of issues and an ethical awareness of concepts such as the common good (an element that may have particular resonance for public managers).

CONCLUSION

The link between ethical leadership and ethical performance is crucial. As Jennings (2006) shows, the appearance of strong leadership without the requisite intent or authenticity is one of the seven signs of ethical collapse in organisations. Public perceptions of an organisation can all too often be, at best, fickle or, at worst, skewed. It is perhaps this area in which ethical leadership becomes most crucially important. An effective leader is outward facing and a figurehead for the entire organisation: he or she is honest about problems that have arisen, and champions the successes where they have occurred. This is why, although ethical performance is difficult to capture it is frequently worth the endeavour.

9. Ethical governance and the Audit Commission

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INTRODUCTION

In this chapter we look at ethical governance in the current political environment with the increased drive for more local decision making. I highlight what the public thinks about locally elected councillors compared with national politicians and then attempt to link these findings to good ethical governance. Finally, this chapter sets out some findings based on the work of the Audit Commission (the Commission) on ethical governance in local government.

CONTEXT

We live in interesting times. I cannot remember another period when, if you did not keep yourself up to date with the government's developments every few hours, you could easily have missed a major announcement. There are a number of consistent themes running through the announcements – the need for greater devolution of responsibility and decision making, greater openness, transparency, democratic leadership and outward accountability, coupled with the need to build public trust and confidence.

Arguably, trust in politicians and public bodies is at an all-time low following events such as those surrounding MPs' expenses. Even so, the new focus on devolution to local organisations and citizens may help to restore and build trust in public organisations. Research suggests that people are more likely to trust public office-holders who are at the frontline of service delivery to tell the truth (Committee on Standards in Public Life 2008). For example, more people trust their local MP and local councillors to tell the truth than trust national politicians.

WHY ETHICAL GOVERNANCE IS IMPORTANT

Ethical governance is a cornerstone of good governance and is one of the key areas of focus in the Commission. The Commission strongly believes that robust ethical governance does matter, both for restoring trust and confidence in public bodies and for helping to ensure that services are delivered effectively.

WHAT THE COMMISSION UNDERSTANDS AS ETHICAL GOVERNANCE

There are many definitions of ethical governance. For example, academics have defined ethics as 'a matter of principled sensitivity to the rights of others', whereas others, such as the House of Commons Public Administration Select Committee, have defined ethics as 'qualities of good governance, such as integrity, legitimacy, accountability, and adherence to a commonly understood standard of behaviour' (House of Commons 2007).

The Commission uses the term 'ethics' in a wider sense and draws upon the definition agreed by the House of Commons Public Administration Select Committee (PAC). The Commission defines good governance as: 'Ensuring the organisation is doing the right things, in the right way, for the right people in a timely, inclusive, open, honest and accountable manner.'

The Chartered Institute of Public Finance and Accountancy (CIPFA) and the Society of Local Authority Chief Executives (SOLACE) have also adopted this as their definition of good governance. It has wide application across local government, police and increasingly within health bodies. This definition makes it clear that good governance is as much about the culture of an organisation and the behaviour of those who govern as it is about hard systems, controls and processes. It recognises that there should be a strong ethical element running through the whole of an organisation's processes.

WHAT WE KNOW ABOUT ETHICAL GOVERNANCE IN LOCAL AUTHORITIES

The Audit Commission has developed a governance tool which can be used across the public sector and one aspect of it focuses on ethical governance in local government. (A full description of the ethical governance toolkit can be found in Chapter 8 of this publication). The Commission's ethical governance diagnostic aims to help local authorities, and those charged with their governance, towards a better understanding of the key ethical governance issues they are facing. The ethical governance diagnostic allows the Commission to assess, with the leaders of an organisation, what their organisation is doing

and how it is doing it. Most importantly, the Commission is able to work alongside organisations to improve both their ethical governance arrangements and their performance.

The ethical governance diagnostic includes an online self-assessment survey, as well as a comprehensive audit and workshops. The Commission's database of the survey results provides a unique insight into the ethical issues facing local authorities in England. Local authorities are able to compare their own results with national results. A unique quality of the ethical governance diagnostic is the ability to compare results between councillors and senior officers in individual local authorities and across the country and over time. It is often the difference in responses between these two groups that gets to the nub of ethical issues and concerns.

By May 2010, nearly 5,000 individual councillors and senior officers from 60 local authorities had completed the survey. In all, over 100 local authorities in England have used at least part of the ethical governance diagnostic.

Although the survey findings are encouraging, they also pinpoint areas where more work and clarity are needed. In particular, the findings suggest that some councillors and senior officers could be supported to develop a better understanding of what ethical governance means in practice. Councillors and senior officers can also differ in their viewpoints; for example, councillors are far more likely than senior officers to think that communication between them and officers is open and that there are high levels of trust. The lack of open communication and trust between members and senior officers can be key factor in preventing improvement.

HIGH STANDARDS AND GOOD BEHAVIOUR

The Commission's findings from the survey show that most local authorities have a positive approach to the ethical governance agenda, but there is room for improvement. A total of 1,344 councillors (84%) and 2,584 of senior officers (76%) consider their organisation's efforts to drive up ethical standards are encouraging proper behaviour. Nine out of ten councillors reported that councillors 'always or usually' show respect and treat fairly all the people who use an organisation's services, treat all

officers fairly and do not discriminate unlawfully. Also, they use public funds and the organisation's property and facilities responsibly. On the other hand, seven out of ten senior officers report that councillors 'always or usually' show respect and treat fairly all people who use organisation services. The results raise concerns about the councillors who are judged by their peers and by their senior officers as not doing this.

Eight out of ten councillors and seven out of ten senior officers consider the leader of their organisation is a positive role model for ethical behaviour. A similar proportion of councillors and senior officers say the same about their chief executive.

ROLES AND RESPONSIBILITIES

Greater communication about the local government ethical framework and a wider understanding of each other's roles would strengthen councillor and officer working and improve fulfilment of the ethical agenda.

A total of 1,152 councillors (92%) believe that they understand their own role and responsibilities under the local government ethical framework. Fewer than three-quarters of senior officers, however, say that they themselves understand their own role under the ethical framework. This means that over a quarter of these senior officers say they do not understand or are not sure.

Almost all councillors are positive about the guidance they receive about their personal conduct, whereas one in five senior officers think the guidelines that councillors receive on councillors' personal conduct are not clear.

Nearly all 1,600 councillors are aware of the councillors' code of conduct, which they are required, by law, to sign when they become councillors. It codifies, for example, the Nolan Principles of Public Life.⁵ Only just over three-quarters of senior officers are aware that councillors have a code of conduct.

Councillors and senior officers often differ in their opinions of the degree of open communication and trust between them. Over three-quarters of councillors believe councillor-officer communication is open. That compares with just

5. Nolan's Seven Principles of Public Life are selflessness, integrity, objectivity, accountability, openness, honesty and leadership to deliver these (Committee on Standards in Public Life 2011).

two-thirds of senior officers who believe this is so. A large proportion (70%) of all councillors are also far more positive than senior officers (51%) about the levels of trust that exist between councillors and senior officers.

More suitable training, guidance and information could provide a solution. For example, fewer than seven in ten councillors and four in ten senior officers consider that councillors receive suitable training on issues of conduct.

Officers could also benefit from more clarity about their own ethical responsibilities. For example, over one-third of the senior officers surveyed are not sure what to do if they become aware of conduct by a councillor that could result in failure to comply with the councillor code of conduct.

COMMUNICATION, CLARITY AND CULTURE

Most councillors and senior officers (78% and 83% respectively) consider the way their organisation deals with complaints against councillors is clearly communicated.

Other findings in this area include that eight in ten councillors say that the importance of high ethical standards is communicated to them. More than half (57%) of councillors say the importance of high ethical standards is communicated to local communities, but a significant percentage (29%) of senior officers do not know if this is done. More than half of senior officers (53%) say they 'don't know' whether the public can easily access the register of councillors' interests.

Nearly one-third of councillors do not know if their organisation has a whistle-blowing policy. Just over 11% of senior officers surveyed do not know, either. This could have serious implications for the standing of local councils and things could go badly wrong before they are put right. Fewer than two-thirds (60%) of councillors have received training, guidance or information on equalities or human rights legislation.

CONCLUSION

The government is putting a great deal of trust in local authorities to deliver increased productivity at the same time that government funding is being reduced. Local authorities need to show central government and the public that this trust is well founded. The Commission's survey results show that there is already much good practice, but there are also key areas where many local authorities still need to take action. Local authorities that have used the Commission's ethical governance toolkit have found it helps to highlight the issues they are facing and provides clarity about what to do next.

10. Assuring company integrity – introducing a tool to protect reputation and shareholder value

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The substitution of written legal contracts for word of mouth contracts has led to an unattractive consequence: it effectively has taken personal integrity out of the equation and ultimately has led to the belief by some that the only questions which matter are: is it legal and is it profitable?

MARCUS AGIUS, CHAIRMAN, BARCLAYS GROUP, OCTOBER 2010

The comment above, from one of the leading bankers of our time, invites us to consider whether, in the pursuit of greater legal and commercial efficiency, the conduct of business has today lost something that, in the longer term, may be crucial to the achievement of both those outcomes. That something is the element of personal integrity, a factor which will cause those acting on behalf of businesses to consider matters in terms not only of whether or not they are expressly prohibited by law or regulation but also whether they are consistent with personal and corporate integrity.

To be clear at the outset, every commercial business, to assure its continuity, relies on making money. There is nothing wrong or unethical about that. Any business, of whatever size, and in whatever sector it operates, needs to identify opportunities to make money and profit. It also needs to try to keep down its costs in a judicious way and manage its commitments to third parties so as to maintain its profitability. Moreover, any business will expect its individual directors and staff to play their full part in achieving commercial success for the enterprise – this will include not only achieving results themselves, but also exhorting and achieving high performance from their teams.

But it is also clear that the pursuit of profit, unconstrained by a disciplined approach to the management of risk, or by a commitment to ethical business values, is not conducive to the long-term interests of a business. Responsible companies now know that it is not sufficient to draft policies for how they expect their business to be conducted – they need actively to ensure that those policies are put into practice. Ultimately the best way for them to do this is to take steps to ensure that their directors and executives are persons who share a common ethical compass and who can be trusted to ‘walk the talk’ of the business values with which they wish their company to be associated.

The issue addressed here is: how are boards supposed to assess these qualities as they select, recruit and develop their executives and directors? Typically, the track record that can be assessed amounts to a series of executive challenges where the individual, once shown a clear goal, has exhibited the ability to achieve it. This method of assessment is not a sure indication of a potentially effective director. It provides no evidence that the individual can rise to the challenge of being a director who is useful in upholding company integrity. Among other skills, upholding company integrity calls for the ability:

- to hold in one’s mind, openly and even-handedly, two or more conflicting propositions
- to have the skills, courage, humility and wisdom to contribute to, maintain, and be faithful to the company’s stated aims and way of doing business under all conditions.
- to handle conflicts in a way that is successful for the board without resorting to any kind of psychological or other violence.
- Over the following pages, a tool is presented to enable boards and senior executives to:
- embrace the necessary breadth of aims for a company operating in a fast-moving complex context, and
- attract, develop and retain directors and senior executives who will uphold company integrity.

This tool, it is suggested, can be applied within most companies’ governance frameworks. The tool is based on the personality types identified in the Enneagram, a body of knowledge developed by several groups and individuals over the last 30 years (Hurley and Dobson 1991; Quenk 2000).

ARTICULATE, CLEARLY AND EXPLICITLY, THE WAY A COMPANY WANTS TO CONDUCT ITS BUSINESS.

To gain the benefit of this perspective, a company board needs to make time to develop, articulate clearly and unambiguously, and record, how it wants to do its business. This can be approached using five areas of board responsibility.⁶ Separately from this analysis, and to secure its future reputation, a board needs to decide how it wants to be known in its communities and wider society for upholding the way it has chosen to conduct its business.

The organisation will need an incentive structure, covering:

- types of engagement contracts for individuals: whether employment, contractual, or retained
- employee remuneration and employee benefits
- performance bonuses: payments in kind
- status and perks
- protocols and consultations for promotion.

Performance assessment will require a broad score card, including:

- short-term and long-term individual contribution
- contribution to the welfare and development of the team over time
- long-term contribution to the welfare of the business
- social contribution inside the company
- role modelling, probity of technical contribution
- contribution to wider communities, especially those recognised by the company.

Communication policies must clearly describe the frequency, style and level of disclosure for:

- formal board communications with employees
- formal board communications with customers
- formal and informal communications with the supply chain
- formal and informal communications with shareholders
- formal and informal communications with senior executives
- formal and informal communications with other stakeholders.

Company symbolism must take into account:

- country, city and neighbourhood of company sites
- quality, style and finish of facilities and accommodation
- brand image, charitable and community support
- employee dress codes, employee and director expenses policies.

Ethical guidelines must address:

- principles to which all company executives are expected to adhere
- a structured process to review the four preceding dimensions
- a structured whistle-blowing, escalation and dilemma resolution protocol.

For a board, becoming clear about how the company wants to do its business is best achieved through debate and discussion with those the directors trust to carry it out. It is important to recognise that this needs to be a continuous process, that the document of the company's intentions must be a living document, and must be kept up to date. The benefit of this approach is that it gives a sense of ownership of the work and its outcomes, rather than being something that has come from above.

6. These are five of the nine types fully described in the body of their texts by Hurley and Dobson, Daniels and Price, and Maitri.

HOW TO FACILITATE THE RECRUITMENT AND RETENTION OF DIRECTORS AND SENIOR EXECUTIVES, WHO, BY ESPOUSING COMPANY INTEGRITY, CREATE AND EXEMPLIFY THE ETHICS TO MATCH

Varieties of candidate limitations: we all have an Achilles heel

One useful approach is to see candidates for senior executive or directorial roles as people with distinctive personalities as well as people with the limitations and style that go with each personality type.

An easy starting point is to observe that a candidate may be one of three types: a 'Thinking' type, a 'Feeling' type or an 'Acting' type. As they make sense of and engage with the world of their experience, each of these types also adopts the other types as their secondary and tertiary skill-sets. It happens like this (Hurley and Dobson 1991).

- 'Actors' act first, think second, and feel last: preservationists, protectors and achievers.
- 'Thinkers' think first, feel second and act last: guardians, observers and idealists.
- 'Feelers' feel first, then act and think last: performers, givers and individualists.

The last skill-set for each type is the least practised and so, on those occasions that circumstances oblige that it be exercised, it is, for that type, the least accomplished skill-set.

This way of observing helps us notice that each of the types normally engages with the world with a particular and persisting motivation. Occasionally, circumstances oblige us to use our least-favoured way of making sense of the world: the one we choose last. This is when our Achilles heel shows up, and reveals us not to be as accomplished as we usually are in our more favoured way of understanding.

Accordingly then, each of these types has a particular way of upholding or potentially betraying company integrity (Hurley and Dobson 1991 and Quenk 2000).

For 'Act then think and feel' types, in the heat of perfect delivery the contingent issues in the wider context and medium term can get neglected, in favour either of the demands of the rules, as they understand them, or in favour of their immediate sense, or 'gut feel', of what is justice in the current situation.

'Think then feel and act' types know exactly what is required by gathering information and analysing it well. Upholding company integrity can, for these types, be sometimes delayed, be left unfinished, or else not happen at all. Knowing is what matters, and such 'doing' as there is may or may not best serve the needs of the situation.

For 'Feel then act and think' types, influenced by their feelings of concern for those important to them, pursuit of their own goals, image or efficiency can be inconsistent with company integrity. Their focus is often on the appearance of success, being in the right networks, or being attractive to others by working hard and delivering.

When they fail in any of these ways, directors and senior executives compromise company integrity. If a company has a director or senior executive in place who is persistently failing in one of these ways, then company integrity risks being eroded over time. Having a number of directors and executives who persistently fail in any or all of these ways will be extremely damaging to company integrity.

HOW TO ENSURE THAT ONLY DIRECTORS AND EXECUTIVES WHO UPHOLD COMPANY INTEGRITY ARE RETAINED

The difficulty is twofold: first, companies are frequently obliged to recruit from younger, and therefore less experienced pools of talent, and secondly, when the track record is assessed, it does not provide evidence of competence in the face of the challenges to be faced in the more senior role. What can be done? We have two new devices at our disposal.

It is becoming clear that it is possible to discern reliably which of the three personality types the person exhibits while still in junior-level roles. Observing how candidates for senior positions are judged by those with whom they work is a useful starting point. Identifying which of the three types – Actor, Thinker or Feeler – best characterises the individual can indicate the person's potential failure modes in the more senior role.

It is also becoming clear how one may confirm that, once in place, senior appointees are usefully applying their energies to their own development. Doing this reduces the likelihood that their personal type of failure mode will occur when in the senior roles.

Discerning which typology the person exhibits while still in a junior-level role

For 'Act then think and feel' types, in the junior role there are three behaviour patterns to look for.

- **Achiever:** achieves the goal. Achievers work hard and persistently to change reality to suit themselves; they are perfectionists who often see shortcomings and work to improve the situation; they structure their projects beforehand, sometimes showing anger when frustrated from accomplishing them.
- **Protector:** pursues position relentlessly, holds it tenaciously. Protectors fight with innate tactical sense to ensure their views prevail; in the face of opposition, they can be tenacious in their struggle for a prized position. Ambitiously competitive, Protectors are often concerned to get justice done, for themselves first, then for others.
- **Preservationist:** maintains harmony, structure and routine to make life predictable. Preservationists maintain a calm exterior; appear unruffled by dramatic situations; in pursuit of harmony, they flex towards the perspective of others, even if this is in contrast to a previous position taken or commitment made.

For 'Think then feel and act' types in the junior role there are three more behaviours to note.

- **Observer:** knows all that is needed. Careful planners, Observers often redefine issues, taking pride in their reputation for wisdom and knowledge. Observers can have a somewhat impersonal approach. Observers regularly need privacy and separation from the world.
- **Guardian:** strives to feel safe and secure by following the rules. Guardians are alert for others' hidden agendas. Taking only calculated risks, Guardians can be unshakeable when backed by law, rule, custom or tradition. Working hard to find others they can trust, Guardians can find positive solutions to the hazards they face. They can be stubbornly selective as regards which law, rule, custom or tradition they invoke, bend or break.

- **Idealist:** has visions of beautiful perfection, while not attending to the tougher demands of the here-and-now. Keeping options open, Idealists tend to move on quickly to the next interesting issue or context, sometimes without completing the current task. Of high energy and sometimes overly optimistic, Idealists can disarm others using charm and imagination. They prefer to maintain a privileged position.

For 'Feel then act and think' types in the junior role there are three behaviours to look for.

- **Performer:** gets the job done; attains status and recognition. Performers constantly work hard to reach their goals. They show flair and savvy and have insight, awareness and initiative. Performers make excellent team leaders and organisers of efficient working. In project working, Performers' talent for free thinking, ideas and communication can serve the project well. They are sometimes insensitive to the contributions of others.
- **Helper:** maintains others' acceptance and approval. Responding usefully to the needs of the moment, Helpers are often perceived as benign advisers, sometimes displaying intense feeling. Quick to support or give advice, they may be perceived as intrusive, overly helpful or controlling.
- **Individualist:** does it in his or her own way, is sensitive to self and others. Individualists attempt to refashion situations by imposing their own design. Frequently analysing the past, or yearning for a rosy future, they sometimes retreat into a private fantasy world.

Confirming that a director or senior executive is developing their ethical compass to uphold company integrity

That people are usefully applying their energies to their own ethical development, and so are ever more ably upholding company integrity, can be ascertained by observing the behaviour patterns of each of the developing types.

For 'Act then think and feel' types there are three behaviours to look for which evidence development in the type.

- **Achiever:** achieves the goal. Development behaviour: is patient with imperfect performance, occasionally

accepting less than 100% attainment, while working persistently for continuous improvement.

- Protector: pursues position relentlessly, holds it tenaciously. Development behaviour: is occasionally enquiring of and sensitive to others' condition, identifying their needs before acting.
- Preservationist: to maintain harmony in the moment, agrees with the other's perspective. Development behaviour: sometimes expresses emotion inappropriately. Occasionally negotiates conflict successfully, sustaining and completing challenging conversations.

For 'Think then feel and act' types there are three more behaviours to look for that provide evidence of development in the type.

- Observer: knows all that is needed. Development behaviour: sometimes shows easy affability. Expresses emotion appropriately in the moment, or shortly afterwards. Occasionally displays generosity, becoming trusting and trustworthy in selected relationships.
- Guardian: strives to feel safe and secure by following the rules. Development behaviour: sometimes, Guardians gracefully exercise their own inner authority, independent of laws, rules, customs or tradition. They can occasionally be assured in the moment, and proceed confidently, finding positive solutions, with little concern for hidden agendas.
- Idealist: has visions of beautiful perfection, while not attending to the tougher demands of the here-and-now. Development behaviour: when they take time for contemplation, Idealists exhibit an increased ability to persevere with emotionally difficult situations. Communicating effectively on the emotional level enables them to see situations through to their necessary conclusion.

For 'Feel then act and think' types there are three behaviour patterns to look for which provide evidence of development.

- Performer: gets the job done; attains status and recognition. Development behaviour: when they recognise their interdependence with colleagues and direct reports, Performers relate well and can mentor

others. This type is sometimes willing to allow other colleagues and reports into the limelight for extended periods and on significant occasions.

- Helper: maintains others' acceptance and approval. Development behaviour: shows authentic, effective caring for others' concerns. Using their tact and cooperative talent, Helpers focus on the practical aspects of keeping an organisation going.
- Individualist: Does it in his or her own way. Development behaviour: identifies and articulates uniquely creative solutions to collective problems; successfully refashions situations with steadfastly constructive actions.

CONFIRMING A DIRECTOR'S OR EXECUTIVE'S ETHICAL PRACTICE

Those concerned with a company's integrity and reputation in its social and environmental contexts increasingly accept that following corporate compliance codes or rules does not in itself deliver ethical behaviour (Jeanes and Muhr 2010). Rather, it is now understood that 'Ethical conduct, whatever its character, arises in the moment of encounter with every other person, every day' (Levinas, quoted in Jeanes and Muhr 2010).

This means that those responsible for senior appointments need to seek evidence of the character of candidates' ethical practice, in each individual director's or senior executive's daily work with others. Do they persistently uphold the company's integrity and its way of doing business?

One way to obtain evidence of this character is to gain first-hand experience of the director or senior executive in action with others. The problem here is that the candidate will know that this is an exceptional assessment, and so could 'act up' for the test.

There is a more reliable way to become persuaded that ethical practice that upholds the company's integrity, and its way of doing business, is actually happening. That is to ask for, and listen carefully to, witness from others, inside and outside the candidate's reporting context, about their experience of the way the director or senior executive concerned is working with diverse others, as they negotiate the difficult ambiguities in their responsibility.

To be sure that the candidate's ethical practice upholds company integrity, its way of doing business, in all his or her interactions for company business, both inside and outside the company, behaviour patterns need to look like this.⁷

For 'Act then think and feel' types in the senior role there are three behaviours to look for that provide evidence of ethical practice.

- Achiever: works with others to deliver what is possible. Achievers uphold company integrity by: accepting the reality that the situation is a mixture of the perfect and the flawed, of strength and weakness.
- Protector: includes the business and personal concerns of others in his or her goals. Protectors uphold company integrity by: taking a back seat and allowing the spotlight to move from themselves to the issues and concerns of engaged others.
- Preservationist: works for well-being for all. Preservationists uphold company integrity by: consistently succeeding in communicating enthusiasm for business as it is, to all their fellows.

For 'Think then feel and act' types in the senior role there are three more behaviours to look for that provide evidence of development.

- Observer: responds helpfully to others' concerns. Observers uphold company integrity by: becoming involved with others' needs; they become more generous, sharing their deep knowledge and clear analysis readily, usefully and gracefully.
- Guardian: works usefully with others. Guardians uphold company integrity by: responding readily to the situation, with open and courageous acceptance of new facts, persistently finding positive solutions.
- Idealist: shows realistic and imaginative dedication to the concerns and condition of all. Idealists uphold company integrity by: taking responsibility to see through the difficult and painful projects to full realisation.

For 'Feel then act and think' types in the senior role, there are three behaviours to look for that provide evidence of development.

- Performer: envisions outcomes consistent with company integrity that are caught by others. Performers uphold company integrity by making others and their concerns important to them. They find meaning in their projects and hard work that is passionately caught by co-workers.
- Helper: unearths multifaceted possibilities that overcome any apparent obstacles. Helpers uphold company integrity by: supporting others' concerns in the best possible way, by giving and taking gracefully in a balanced way, affecting the situation for the better.
- Individualist: penetrates to the core of experience, uniting new and scattered wisdom. Individualists uphold company integrity by: bringing their clear thinking and skills with words and ideas to the endless opportunities they discover.

Boards work well when they are made up of 'all the talents'. So the users of this tool can make best use of it not by selecting like-spirited individuals to join them in their perspective, but by striving for balance and breadth in their number. In this way, with a diversity of talent, a well-balanced board will find that it can make a better job of developing, articulating clearly and unambiguously, and recording, how it wants its business to be conducted.

CONCLUSION

Leadership groups who take the time to raise their awareness in the ways described above can appoint better directors and senior executives. This sets the optimum conditions for the work of developing, articulating clearly and unambiguously, and recording how they want their company's business to be done.

It also ensures that keeping this record as a living document, one that is revisited as necessary, is most ably done.

It is by listening, early, to that still small voice of concern that directors can engage with colleagues and lead effectively.

7. These behaviours are variously described in the body of their texts by Hurley and Dobson (1991), Daniels and Price (2009), and Maitri (2001).

11. Ensuring good ethical governance in partnership arrangements

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INTRODUCTION

Recent scandals in both the public and private sectors have led to greatly increased concern about standards in both sectors, internationally. In Britain we have seen the British Aerospace Systems bribery scandal, while the furore over MPs' expenses has significantly damaged trust in the political class.

While ethical governance issues affect both sectors, and ethical scandals have detrimental impacts, there is a dearth of work that considers public and private sector issues together. Indeed, one can be forgiven for believing them to be two distinct realms, with mutually exclusive problems. Yet we live in a world where the public and private sectors increasingly work together to provide services and overcome problems. At a local level in the UK there is an emphasis on provision of services by local government acting in partnership with others, including the private sector. Such relationships offer opportunities to provide services to meet the needs of service users and customers in innovative ways. Nonetheless, there are differences in cultures, values and governance structures, including ethical governance, which represent a risk if not addressed appropriately. To ensure a successful partnership the partner organisations must seek a 'cultural fit' (Ugoji et al. 2007).

The current economic situation only heightens the need for vigilance against poor standards of behaviour, as it is in those economies recovering from recession where fraud and corruption are often found (Connolly 2010).

People involved in partnership arrangements frequently make decisions or allocate resources that affect the lives of the wider public without necessarily being accountable for those decisions. Ultimately, local people should be able to see that those making the decisions in their area, whether in the capacity of a local business person sitting on a Local Strategic Partnership (LSP) or their elected member, are not bolstering their own protected interests but have to account publicly for their decisions. It is important that high standards of behaviour are built into any system where people are making decisions on behalf of the wider public.

This chapter outlines why ethics are important in both sectors, highlights some of the key problems in how ethics are interpreted in both sectors and goes on to outline an approach to resolving these problems. The intention is that resolving these ethical governance issues will prevent the scandals referred to earlier from finding expression at the local level.

WHY ARE ETHICS IMPORTANT?

An ethical environment can have an impact on both public and private sectors. Some key examples are explored below.

Profit and performance

Studies by the Institute of Business Ethics (IBE) have made a link between ethics and profits (Webley and More 2003; Ugoji et al. 2007), and research carried out by CFO Research Services (CFO 2007) found a correlation between having practices likely to result in ethical behaviour, such as training on ethics, and financial performance. Transparency International suggests that bribery and corruption played a role in the current global economic problems (cited in Archer 2010). In the public sector, good ethics are viewed as part of good governance, which then leads to good performance and good outcomes (eg CIPFA/SOLACE 2007, Audit Commission 2003).

Staff motivation and morale

The 2007 CFO research found that CFOs believed that a strong ethical culture had a beneficial impact on staff loyalty, trust and motivation. Similarly, a study by IPSOS/MORI concluded that 'aligning corporate values with employee ethics had a significant impact on employee engagement.' (MacLeod and Clarke 2009).

Trust and reputation

Trust is an especially important commodity for politicians, while businesses are built on reputation. Lack of trust in politicians can harm their reputations and electoral chances and undermines credibility in our democratic process. There are similar risks in the private sector; Carmichael (1995) notes that business suffers when its legitimacy is questioned by shareholders and the public.

Drain on resources

Some scandals result directly in the loss of funds from organisations. For example, the ‘votes for homes’ scandal at Westminster City Council in the 1990s cost the taxpayers millions of pounds. Embezzlement in the private sector clearly results in a loss of money for those firms affected. In addition, poor ethical practices can result in government intervention and subsequent costs.

So, ethical problems can pose a risk to both the private and public sectors.

APPROACHES TO ETHICS

It is not the purposes of this chapter to outline the philosophical underpinnings that might answer the question ‘what is ethics?’ Indeed, in the private sector, given the variety in nature and scope of businesses there is, not surprisingly, ‘still considerable confusion about the nature and scope of business ethics’ (Carmichael 1995). Rather, we want to draw attention to the broad differences and similarities between local government and the private sectors.

In a local government context when one talks of ‘ethics’ this is usually in reference to the ‘local government ethical framework’. This framework includes the following key elements:

- a code of conduct, based on seven principles of public life, to which all councillors must sign up
- a standards committee, made up of elected and lay members, with responsibility for promoting and ensuring high standards in the authority

Failure to adhere to the principles can result in a variety of sanctions up to disqualification for five years. The code applies only to councillors and not employees and focuses on the integrity and ethical behaviour of individuals. In this sense, the interpretation of ethics is very narrow. Perhaps this could be one of the reasons behind the government’s decision to abolish the current code and ethical standards regime. Until now, this ethical framework has sat within a wider ‘web of accountability’ (Centre for Public Scrutiny (CfPS) 2010), which includes an overview and scrutiny committee, made up of elected members). The overview and scrutiny committee has responsibility for holding the executive to account and can scrutinise how decisions are

made in policy development, and can review policy and performance. More recently, these powers have expanded to cover partnership working.

In contrast, there is no unified ‘code’ or approach in the private sector. Also, in the private sector a broader definition of ethics may be adopted to include legal requirements as well as other issues; for example, the impacts of a business on the environment, or how an employer treats its staff. Much of this is considered as corporate and social responsibility (CSR). That is not to say that local government organisations give no consideration to such issues, but rather that they are less likely to include or think about such issues in relation to a discussion about ethics.

What is clear, though, for both local government and private business, is that ensuring high standards involves systems and processes as well as culture and values, with the latter often expressed via codes of conduct. For example, in local government there are the aforementioned standards committees and a process of investigation for dealing with alleged breaches of ethical principles enshrined in a code of conduct, while large companies will often have codes of ethics overseen by audit committees or ethics/corporate responsibility committees.

Given the context of increased partnership working between local government and the private sector, there needs to be a common dialogue about what ethics means for both. This will enable an assessment to be made about the compatibility, or ‘cultural fit’ (Ugoji 2007), of prospective partners as well as enabling them to develop mechanisms for ensuring effective scrutiny of partnerships.

LOCAL GOVERNMENT AND PRIVATE SECTOR PARTNERSHIPS

The emphasis on a geographic ‘place’ or area, and the harnessing of resources and organisations to affect that place, has resulted in a growth in the number of partnerships between local government and other public sector organisations; local government and the private sector; and local government and the third sector. It follows that there has been a growing awareness of the importance of the governance arrangements of these partnerships.

In the current economic climate, with the parlous state of public finances and a coalition determined to roll back state provision, it is likely that there will be an increase in public–private partnerships and outsourcing of services once provided by the public sector. Indeed, partnerships can often result in innovative ways of delivering services in a cost-effective way.

For a partnership to work it is vital that there is some level of compatibility between the culture and values of the organisations.

What then are the problems and risks involved in such partnership arrangements and how can they be minimised? How can they be minimised without stifling innovation and without the development of a disproportionate regulatory burden? To answer these questions we first of all undertook a small literature review and interviews with 19 individuals from both the public and private sector and have now developed a tool that is currently being piloted.

So, what are the problems?

There is substantial evidence that partnership working can compromise accountability (Jones and Stewart 2009). Research undertaken for Standards for England by the University of Manchester (Greasley et al. 2006) highlighted the problems of differences between organisations in partnership with respect to openness and transparency, inconsistency between the partners' codes of conduct, and the difficulties of enforcement. A further problem, and one identified in the Councillors Commission Report (Councillors Commission 2007), is that the plethora of organisations involved in the provision of services, combined with the various governance arrangements, makes it difficult for the public to understand local governance arrangements, and subsequently it is hard for them to feel a sense of engagement with what is happening at a local level. The Centre for Public Scrutiny's 2009 annual survey found that officers and members considered that partnerships were an area where scrutiny was least effective (CfPS 2009).

In the literature review a range of issues were raised, including some that were specific to particular types of partnership. So, for example, some LSPs were found to have weak profiles and credibility, confusing and conflicting accountability, poor control, complex governance and weak management structures. So, there

were many governance problems but little or no evidence of any ethical issues.

Nonetheless, what has been unclear is the extent to which there is a 'standards' or 'ethics' component to these governance concerns. Within this context we have undertaken the aforementioned literature review and series of interviews with people involved in partnerships.

A range of governance issues were raised in the interviews, including concerns about the democratic deficit in partnerships, conflicting priorities and the importance of relationship building. All the respondents noted that, in their experiences, there were in practice few actual problems around ethical behaviour and the Code of Conduct. Although it is worth noting that some respondents did report some behaviour issues, these issues seemed to be less about ethics and breaches of the Code and more about cultural differences, for example, answering a mobile 'phone during a meeting.

That said, the potential for ethical problems was acknowledged and two particular issues merged.

Partnerships should adhere to the seven principles underpinning standards in public life. Some respondents noted that where partnerships involved the allocation of tax payers' money and decisions that affected local communities, then it was only right that these partnerships should adhere to the seven principles of public life. It follows that there should be proper scrutiny of partnerships.

Local government needs to ensure that partner organisations are compatible with the local authority. Local government, and the public sector generally, does not put a sufficient level of resources into ensuring that their partners are compatible, before engaging in partnership working. Many suggested that authorities were often more concerned with value for money than they were with the extent to which a potential partner was compatible with its own values. For a partnership to work there needs to be some compatibility between the values and cultures of the organisation, and an attempt to build up a relationship before embarking on the partnership proper. Indeed, poor relationships and incompatible values and culture were often cited as reasons for partnership failures (alongside many other factors such as lack of clarity regarding objectives and outcomes).

Addressing the risk of poor ethical governance

What is required is a framework of values to which all decision makers agree to adhere. This does not mean a ‘one size fits all’ set of rules. Indeed, it has been suggested that the imposition of ethics from above may actually be unhelpful and counter-productive (Davies et al. 2010). There does, however, need to be an accountability framework that is commensurate with the risk involved in the necessary decision making, that does not duplicate existing regulatory safeguards and that helps ensure public confidence in local governance systems. We need to ensure that the emphasis on innovation in partnerships, on the one hand, is matched with clear and proportionate accountability, on the other.

To this end we recommend the use of two tools to mitigate poor ethical governance of partnerships. We are writing from a local government perspective and it is the overview and scrutiny committee, with support from the standards committee and audit committee, that would be well placed to use these tools. The tool could be used in a local authority’s annual governance statement as a demonstration of how it has sought to ensure good ethical governance. Collectively, these committees have responsibility for promoting ethics and ensuring scrutiny and good governance. Other partners may, however, want to suggest additional ways in which they could be used.

Tool 1 should be used ‘pre-partnership’ and allows for prompt consideration of whether organisations that plan to work together have compatible values and cultures. It will also enable any risks of incompatibility to be identified, discussed and addressed.

Tool 2 should be used during the partnership and provides a list of considerations that might trigger a scrutiny review of the performance of a partnership in maintaining high standards. In the event that a scrutiny review judges that some partnership behaviour falls below a required standard, or a partnership does not have sufficient ethical governance arrangements to support high standards, it can make recommendations for improvements.

Ideally these two tools should be used together. Figure 11.1 gives an overview of the two tools.

Figure 11.1: Tools for aligning values and scrutinising standards

Tool 1: Checklist for pre-partnership commitment to ethical standards

Who: Prospective partners to align value

When: Prior to partnership start

Partnership values	Do partners feel they can commit to some common values?
Ethical controls and policies	Can partners agree to having formal ethical governance arrangements?
Complaint handling and whistle blowing	Should partners agree arrangements to integrate these into partnership?
Transparency	Will partnership decision making be transparent?
Monitoring and reviewing	What processes do we need to monitor our compliance with ethical policies?

Tool 2: Checklist for ethical scrutiny of partnership arrangements

Who: Standards or overview and scrutiny committee

When: Specific trigger points or built into committee programme

Partnership values	Evidence partners adhere to their behavioural values
Ethical controls and policies	Review existing partnership governance arrangements
Complaint handling and whistle blowing	Analysis of any complaints made internally or externally
Transparency	Evidence to show partnership is committed to be transparent
Monitoring and reviewing	Review evidence to determine if partnership is committed to monitor and review

The tools have been developed using a three-stage iterative process.

1. A literature review was carried out covering both private and public sectors. Initial drafts drew on information from a number of sources, including the Institute of Business Ethics (IBE), previous work on behalf of the Centre for Public Scrutiny (CfPS) and Local Government Improvement and Development (formerly the IDeA).
2. We received feedback from the steering group, which included representatives from the Audit Commission, IBE, CfPS and the Local Government Association.
3. There was a round-table discussion with representatives from the authorities piloting the tools.

The first two stages were used to design the initial tools, while the third stage assisted greatly in giving the project an important 'reality check' in how they could be applied in practice. A key outcome from the round-table discussion was that the first checklist must be a 'mutual' agreement rather than a top-down 'enforcement' from authorities.

The tools are currently being piloted by six authorities, including two London boroughs, one non-London borough council, one metropolitan council and one city council.

The following gives some further explanation of the subjects underpinning the two tools and an indication of the types of question that would be asked under each subject heading.

TOOL 1: SELF-ASSESSMENT CHECKLIST – QUESTIONS POTENTIAL PARTNERS ASK OF EACH OTHER AND OF THE FUTURE PARTNERSHIP

Tool 1 can be used to assess 'cultural fit'. Potential partners are asked to consider each other's arrangements within each of the headings and then determine whether the arrangements are compatible or whether an agreement on arrangements can be reached.

Subject A: Partnership values

This subject area focuses on the extent to which the values of the respective partners are compatible. Asking for evidence of organisational commitment to values and how organisations treat staff and customers can provide a useful starting point for establishing the values of an organisation.

Subject B: Ethical controls and policies

This subject area looks at what ethics protocols and policies each partner already has in place, and what arrangements should be established in the new partnership to manage issues such as conflicts of interest, whistle-blowing and complaint handling.

Subject C: Arrangements for complaint handling and whistle blowing

With regard to subject B above, if ethical controls are considered necessary for the new partnership, how can they be integrated into it? For example, is there a template from which to draw? What system should be agreed for recording and investigating complaints?

Subject D: Transparency – will partnership decision making be transparent?

Partners will need to agree arrangements for ensuring that their decision making is transparent and made in the wider public interest. So the partners will need to consider, for example, how they think evidence of performance and value for money could be made available to the public.

Subject E: Monitoring and reviewing

Partners will need to agree arrangements to monitor their compliance with any ethical protocols or arrangements they agree are necessary for the partnership. Hence, the prospective partners should consider how they each currently assess and ensure compliance.

TOOL 2: ETHICAL SCRUTINY OF PARTNERSHIP ARRANGEMENTS

If parties agree to a partnership arrangement then this tool can be used to ensure effective ethical scrutiny of the partnership.

Theme 1: Partnership values

The partnership is scrutinised to ensure that the partners adhere to the agreed values. This scrutiny may take the form of observation of behaviour at meetings; this would enable the collection of evidence on the extent to which, for example, partners behaved respectfully to each other and whether poor behaviour was effectively challenged.

Theme 2: Ethical controls and policies

This theme considers the proportionality and effectiveness of the controls and policies in place in the partnership, including terms of reference and accountability arrangements.

Theme 3: Monitoring complaints and speaking up/whistle-blowing

A potential element for a scrutiny review could be an analysis of any complaints that have been received by the partnership, either internally or externally.

Theme 4: Transparency – is the partnership’s decision making transparent?

Scrutiny should examine the extent to which the partnership is committed to transparency, including whether meetings are open to the public and/or how information is made available to the public.

Theme 5: Monitoring and reviewing

Evidence should be sought to show whether the two parties have arrangements to monitor and review their compliance with their ethical policies.

CONCLUSION

It is increasingly being recognised that high ethical standards are a crucial part of good governance within both the public and private sectors. Good governance leads, in turn, to good decisions and good services. Poor ethical governance risks poor performance, low staff motivation and morale, damaged reputations and a loss of trust from stakeholders.

Local government, in partnership with others, makes decisions and allocates resources on behalf of the electorate. It is vital that those involved in these decisions are held accountable for them and that these decisions are not made in self-interest or in breach of any ethical codes.

Partnerships between local government and the private sector are increasing. Differences in ethical values and lack of cultural fit are risks that can lead to difficulties within such partnerships. This chapter has outlined two tools that could help mitigate this risk. One tool ensures that potential partners can assess their compatibility prior to embarking on a partnership arrangement while the other ensures effective scrutiny of partnership arrangements.

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