ACCOUNTANTS FOR BUSINESS

Risk and reward: tempering the pursuit of profit

executive summary

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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 pursuit and achievement of profit, whether motivated by individual or corporate ends, does not necessarily correspond with the notion of sustainable 'success'.

The challenge for a responsible business is to find ways to ensure that the rewards it seeks are supported by sensible management of the risks that confront it.

This report discusses the complex issues, particularly the ethical and behavioural factors, which must be addressed.

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THE AUTHORS

John Davies, Head of Business Law, ACCA
john.davies@accaglobal.com

Paul Moxey, Head of Corporate Governance and Risk Management, ACCA
paul.moxey@accaglobal.com

Ian Welch, Head of Policy, ACCA
ian.welch@accaglobal.com

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The verb to temper:

1. To moderate or control, eg temper your language around children, temper expectations.

2. To heat-treat a material, turning something brittle into something stronger.

Recent events have amply demonstrated that profitability can also be brittle. This paper suggests that its pursuit should also be tempered so that it is stronger, and therefore more sustainable, and well controlled.

THE ISSUE

The financial crisis that broke in 2007 was characterised by a perfect storm of contributory factors, all of which came together to create the most serious and sustained attack on the global financial system since the 1930s. As has already been discussed in two recent ACCA policy papers – *Corporate Governance and the Credit Crunch* and *The Future of Financial Regulation* – a number of headline factors have been widely identified as playing a significant role in the build up to the crisis.

- In some cases there was poor management of economic and monetary policy at the national level.
- International economic trends were not identified and dealt with appropriately by governments, regulators and businesses alike.
- Governments and financial sector regulators failed to impose the 'right' rules and failed to exercise their supervisory functions efficiently and in good time so as to reduce the likelihood that entities would proceed to endanger themselves and their stakeholders.
- Boards of directors failed to exercise effective control over the operations of their companies: in particular, non-executives failed to fulfil their specific function of supervising the acts of the executive.
- Fair value accounting rules were thought by some to have exacerbated the problems experienced by individual institutions by increasing the level of write-downs they were forced to make when the market for many financial products dried up.
- Credit rating agencies gave misleading indications of the level of risk associated with some financial products.
- Individual companies in the financial sector failed to manage properly the various risks they were running: in particular, the dangers of allowing themselves and individual members of their staff to pursue potentially lucrative but high-risk activities were not properly assessed and mitigated.

Risk and Reward: Tempering the Pursuit of Profit takes a fresh look at the circumstances which led up to the financial crisis and focuses on the question of how companies can most effectively balance their entrepreneurial ambitions with their responsibilities to their stakeholders and their need to be sufficiently prudent in the planning and execution of their activities as to give themselves the best chance of safeguarding their own long-term positions. The report sheds light, in particular, on the failings on the part of some companies in the run up to the crisis to address effectively the issues of reputation risk and so-called 'people risk'.

It argues that one of the lessons of the financial crisis has to be that more and more regulation is not necessarily the answer to preventing future crises in the commercial environment. Ultimately, we have to address and resolve the behavioural issue of why individuals behave in the way they do, always bearing in mind that corporate scandals and collapses have occurred over the years in many different forms and irrespective of the structure of the prevailing regulatory systems. The paper calls for business entities to adopt a strong commitment to ethical business practices and to integrate them fully into their organisational

cultures. The adoption of a strong and genuine commitment to ethical business conduct should not be seen as an optional extra – it can act as the first line of defence against the dangers posed by the large and growing range of risks that companies face.

THE NATURE OF BUSINESS

It should be acknowledged at the outset that business entities of all kinds need to make money. Without revenue no business can hope to achieve its aims, whether these are primarily commercial or philanthropic. A business that does not earn money cannot hope to raise finance, make profits, reward investors, invest for the future, meet its corporate and social responsibilities or, last but by no means least, pay its suppliers and staff. If it cannot do any or all of these things, the authorities also stand to suffer from lost tax income, to the disadvantage of all. In a properly competitive economy, to earn money a business must provide a service or product that people want to buy. The growth of commerce and trade has contributed to improved living standards across the world.

The entrepreneurial spirit and the profit motive are thus integral to the successful conduct of business anywhere. The economy, and society as a whole, benefit when businesses carry out their operations successfully. It follows that the encouragement of business activity, at all levels, should be a key aim of public policy in a free market economy, and the pursuit of profit should be seen as being of positive social value.

But with freedom has always come responsibility, and any private enterprise which aims to succeed over the longer term will need to be aware of the various threats and challenges to its viability and adapt its behaviour accordingly. In short, it needs to balance risk and reward.

THE MANAGEMENT OF RISK

It is clear that risk has not been addressed with sufficient respect or understanding by many institutions in the financial sector. The link between risk and the rewards earned by individuals was not given sufficient consideration, and the risk function itself was undervalued, being kept too far down the corporate pecking order to be effective. Many claim that this has changed since the crisis broke in 2007, but questions must still be asked about how genuine and permanent this change is going to be.

THE NATURE OF RISK IN BUSINESS

Business activity is inherently risky. Whenever entrepreneurs start up in business they risk losing their money – not for nothing is equity investment commonly referred to as 'risk capital'. Around half of new businesses fail during their first three years, and businesses will always fail irrespective of prevailing economic conditions. Risk can never be eliminated from business, and it would be wrong for regulators or governments to think they can ever do so. It is risk that characterises commercial activity and which creates opportunities. We have to acknowledge that risk must be managed, and can not be removed. Nevertheless, some risks cannot be managed and are too big for companies to take or for society to tolerate. In regulating risk, therefore, governments and regulatory bodies must aim to strike a balance between, for example, ensuring that banks are sufficiently capitalised so as to withstand downturns, and avoiding over-cautious requirements which prevent banks going about their socially beneficial business – which includes lending to businesses and individuals.

RISK FAILURES

As already stated, defects in the way that businesses manage risk have already been identified, by many commentators, as constituting one of the chief causes of the financial crisis. Put simply, in too many cases, businesses failed to recognise the nature and scale of the risks they were taking on and failed to take appropriate pre-emptive action to guard against the prospect that things could go wrong. The many inquests that have taken place in the immediate aftermath of the crisis have argued, in our view correctly, that companies, especially those in the financial sector, must pay more attention to the management of risk and should give the risk management function the internal status, authority and resourcing that it needs in order to be as effective as it should be. This is a positive development and one which seems to have been accepted by the business community. But it is vital that the lessons learned are retained over the long term, and that improvements in the wider economic situation, if and when they do occur, do not cause businesses to scale back the changes, and the financial investment, that they may have made in improving their risk management.

THE HOLISTIC APPROACH TO RISK

Taking a more effective approach to the management of risk involves being aware of the fullest possible range of risk factors which have a bearing on business plans, and taking rational actions to mitigate them. Traditional theories of corporate behaviour suggested that companies needed to be aware of little more than their shareholders' expectations of regular distributions of capital, to which they would respond by pursuing the type of activities that they considered would generate short-term profits. In this scenario, companies' actions would be influenced largely by the risk that, should they not satisfy their investors' demands for short-term profits, their supply of capital would dry up. Considerations of the longer-term viability of the company, and of the effects of the company's actions on consumer perceptions and the company's brand image, would be of secondary importance, if they were thought important at all.

This narrow interpretation of company and (particularly) shareholder motivations still holds good to some degree, and some investors will continue to invest for the short term and seek immediate returns of capital and short-term appreciation of share values. But developments in company law, in the regulatory environment and in the area of stakeholder engagement are now combining to make it abundantly clear that a company which fails – or refuses – to see the fuller picture and the longer-term consequences will not be acting in the best interests either of itself or of its

investors. For example, if a company conducts its operations recklessly, such that it causes substantial pollution to the natural environment, it will not only risk incurring criminal and civil penalties (which will act directly as a drain on shareholder funds) but may incur potentially even more serious repercussions in the form of adverse consumer reaction. Similarly, a company which pursues short-term profit with a lack of concern for the manner in which it does so, or for its ability to continue to function effectively in the longer term, will fail to defend the longer-term economic interests of its investors, employees and creditors. Identifying all the relevant risk factors, and dealing with them appropriately, must therefore be part and parcel of sound financial management.

THE ROLE OF GOVERNMENTS AND REGULATORS

The scale of the regulation of business seems inexorably to increase. This is especially so in the listed company sector where the onus to protect stakeholders is most apparent. Each successive business crisis that we go through seems to trigger calls for more regulation.

But the fact that such events continue to happen suggests that the correct disciplines are not being applied. There are four possible reasons why this is so.

- There has been a failure to frame regulatory controls in the way which is most likely to achieve the desired regulatory outcomes.
- The process of regulation is seen by the regulated parties as a bureaucratic burden, with no fundamental relevance to the way they conduct their business.
- There is a lack of effective supervision and enforcement of regulatory rules or principles.
- Business has failed to show genuine commitment, not only to complying with the objectives which lie behind externally imposed compliance obligations, but also to the fundamental virtue of acting in a commercially responsible – or ethical – way.

The last of the above explanations is the one which we now identify as being the key to future improvements in business regulation. Experience suggests that, whether regulation is presented as rules-based or principles-based, or heavy or light-touch in its impact on individual entities, the reality is that, too often, the system does not work quite as intended. Even where the clear intention is that individuals and businesses should follow the spirit as well as the letter of regulatory requirements, the process can sometimes foster a culture where individuals feel prepared or motivated to ignore the requirements if they feel it would be in their material interest to do so. It is this fundamental behavioural issue that needs to be addressed and resolved if business practices are to be improved in the long term. And whether a regulatory system is based on broad principles or hard and fast rules, appropriate behaviour from individuals will be facilitated by the existence of an organisational culture which promotes and supports such behaviour in terms of policy and practical application.

DEVELOPING ETHICAL STANDARDS

In the development and implementation of ethical business practices, there is certainly a place for codes of practice and principles developed by industry groups and regulators. Elected governments are also within their rights to impose their own standards of morality on the business community. But it can be dangerous to impose on businesses, from above, standards of morality which appear to be well-meant, but which have the potential to conflict with the efficient running of a business. An example of this is the Clinton administration's efforts in the US to pressurise mortgage providers into facilitating increased home ownership among some of the poorer sections of US society, a move which led indirectly to the sub-prime crisis.

To be effective, ethical practices within commercial organisations need to support the profit motive and not suppress it. They also need to be relevant to the way each business operates, woven into the culture of each and, crucially, adopted by individuals of integrity within the organisation. The lead for this process must come right from the top. Businesses, and where appropriate regulators, should acknowledge the business benefits of recruiting and developing staff, especially senior executives, directors and financial staff, who have a strong ethical 'compass'. This involves more than merely aiming to stay within the law or to comply with a code or set of rules – it means recognising that acting ethically and with due regard to the interests of stakeholders is in the sustainable, long-term interest of the company.

THE ROLE OF REPORTING

Disclosure of information on any aspect of a company's operations can be helpful both in terms of communicating helpful information to stakeholders and in terms of explaining the level of a company's commitment to those matters. An undertaking to disclose information on matters such as risk management practices and ethical standards also serves the purpose of causing the reporting company to think carefully about what it is doing and to try to achieve good standards of practice in those areas. Business entities which wish to commit themselves to good practice in matters such as risk management and ethical practices should therefore consider reporting on such matters in their annual reports and accounts. The more imaginatively they do this the better – for example, even those companies that do report on these matters do not say much in their reports about their corporate values and how they go about ensuring that their staff act in appropriate ways. Reporting on such matters would help them to focus on the business benefits of having an ethical culture, and reduce the risk of an ethical lapse and the potential ensuing reputational damage, not to mention the wider economic damage.

CONCLUSION

Laws and regulatory rules, and supervision of compliance with them by regulatory bodies, have important roles to play in the encouragement of corporate social responsibility. But there are limits to what those processes can achieve by themselves. We must in particular acknowledge the risk that too great a focus on regulatory compliance will engender a 'tick-box' attitude, on the part of companies, which concentrates on the letter of compliance rather than the spirit: as we saw in the conduct of Lehman's prior to its collapse in 2008, such an attitude can cause companies to manipulate rules and engage in so-called 'regulatory arbitrage' if doing so is likely to produce an outcome which they regard as being commercially favourable.

Risk and Reward argues that we can draw three main conclusions from recent experience which we need to address and resolve if we are to secure substantial and long-lasting improvements in the way that the corporate sector behaves.

Firstly, while all business entities are perfectly entitled to pursue profit, both in the short and the long-term, it is in their interests and the interests of their stakeholders that they allocate sufficient resources to enable them to identify and understand the various types of risk that confront them in both scenarios, and to manage those risks as effectively as they can. The aim must be to ensure that the pursuit of short-term profit does not expose the entity to long-term risk, and vice versa. Shareholder value should be seen not solely in terms of an entity's ability to generate short-term profits but in terms of its ability to attend to and manage all the factors which have a bearing on its long-term viability.

Second, the experience of the financial crisis tells us that there is a particular need for business entities to address and resolve the areas of reputation risk and 'people risk'. With regard to the former, large companies are today subject to a continuously expanding framework of regulation which exposes them to very substantial penalties where they breach their obligations. In addition, consumers today are better informed than ever before about corporate practices, and bad publicity about the policies or activities of any individual entity will always carry the risk of commercial repercussions. 'People risk' refers to the risk of individual directors, employees or agents acting in a way which causes direct or indirect harm to the entity. While such conduct may not be intentional or unethical, the potential damage that can be caused to a business entity by the actions of its own people is substantial. All businesses need therefore to take these two aspects of risk very seriously.

Third, it needs to be understood that, ultimately, the decisions of business entities are taken by individuals. As such, it is in the interests of all entities, and their stakeholders, to ensure that the persons appointed to take decisions, particularly at senior level and on financial matters, are not only competent and qualified to perform their role but are persons of integrity and trustworthiness. Entities can usefully enhance their ability to achieve this outcome by adopting appropriate internal principles and practices and by developing an organisational culture which supports ethical business conduct.

RECOMMENDATIONS

- Businesses should prioritise the recruitment of senior executives and financial staff who have a strong ethical compass.
- Businesses should ensure a strong ethical culture; this should include setting the right tone at the top and then ensuring, and monitoring, that this is reflected throughout the organisation. Listed companies should set out how they do this in their annual reports.
- In complying with external regulatory requirements, businesses should strive to avoid effectively 'outsourcing' their sense of ethical responsibility.
- Businesses should maintain the higher internal profile given to the risk function since the onset of the financial crisis and not be tempted to cut this back when recovery sets in.

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