Mark Schacter
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What Directors Need to Know about Corporate Social Responsibility

by Mark Schacter

www.schacterconsulting.com

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Published by:

Mark Schacter Consulting
5 Linden Terrace
Ottawa, Ontario Canada
K1S 1Z1

www.schacterconsulting.com

mark@schacterconsulting.com

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by Mark Schacter

What was once often a comfortable, and lucrative, sinecure is beginning to look like the job from hell.[1]

1. Introduction

The discussion about corporate social responsibility (CSR) is really a special type of discussion about corporate governance, and is therefore highly relevant to the role of the corporate director. This paper aims to help corporate directors appreciate CSR's relationship to the exercise of corporate power, and equip them to engage with executives on the strategic question of how to manage the full range of the corporation's relationships with the world around it. It argues that over the next few years, four developments related to CSR are likely to have a major impact on the job of the corporate director:

- growing pressure on corporations to give "stakeholders" (see Box 1) a role in corporate governance;
- growing pressure on corporations to disclose more and better information about their management of social, environmental and economic issues;
- an increasing level of regulatory compulsion related to elements of corporate activity that are currently regarded as voluntary forms of social responsibility;
- growing interest by the mainstream financial community in the link between shareholder value and non-financial corporate performance.

2. Tough Job, and Getting Tougher

As the quotation at the head of the paper suggests, a corporate board member's job is more demanding and nerve-wracking now than it was as recently as three years ago, when the facade of Enron Corp. was just beginning to crumble.[2] The popular revulsion and regulatory tightening spawned by Enron, and by the equally spectacular collapse of WorldCom Inc.[3], have shone an unforgiving light on the director's role as protector of

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[1] "No more Mr. Nice Guy. Independent directors at big public companies need to be tougher," *The Economist*, March 18, 2004.

[2] On Oct. 16, 2001, Enron reported a $638 million third-quarter loss and disclosed a $1.2 billion reduction in shareholder equity, partly related to partnerships that hid large amounts of debt as well as writedowns in money-losing broadband and water trading ventures.

[3] In March 2002, the US Securities and Exchange Commission began an inquiry into WorldCom's accounting practices. In late June, WorldCom announced the firing of its chief financial officer and a

shareholder interests against the greed, or just plain bad judgment, of corporate executives.

A range of surveys shows that directors have indeed been feeling the spotlight's glare. Sensing heightened pressure to be more effective overseers of corporate executives, directors are working harder, and with a higher level of anxiety, than in the days before the twin scandals. Boards are meeting more often, and for longer periods of time. And many directors feel that amplified expectations related to their fiduciary role are raising the risks of the job to an unacceptable level. Nearly half of directors responding to a recent survey said they had turned down a board position because the risk was too great.[4]

Now, the director's job promises to become even more demanding. To date, the increased pressure on directors has related primarily to their traditional role of ensuring that the behavior of corporate executives is aligned with the interests of shareholders. But recently there has been a tendency to push directors into new governance territory occupied by stakeholders as opposed to shareholders. While pressure on corporate *executives* to pay greater heed to stakeholder concerns and bring CSR closer to the center of corporate strategy has been mounting since the early 1990s (see below), such pressure is only now beginning to filter through, in a meaningful way, to the board table. This emerging new perspective was on display earlier this year at a conference – sponsored by Harvard University's Kennedy School of Government – of business leaders, academics and civic advocates, where it was observed that "there will be increased pressure for directors to demonstrate that they have adequate understanding of stakeholder interests and CSR issues."[5]

Box 1 – Stakeholder

The term "stakeholder" refers to groups that are likely to feel a significant impact – positive or negative; social, environmental, economic or financial – from corporate actions, and therefore have a "stake" in the corporation. Key corporate stakeholders include investors (shareholders), suppliers, customers, employees, government regulators and members of communities where the corporation operates or that are affected by corporate activity. Although the term "stakeholder", in its broadest sense, includes shareholders, most discussions about CSR distinguish between shareholders and all of the rest of the corporation's stakeholders. This emphasizes the point of view that corporate responsibility and accountability ought to extend beyond investors to other stakeholders. The convention of distinguishing between "shareholders" and "stakeholders" is followed in this paper.

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restatement of its financial results for 2001 and the first quarter of 2002. The following day, the SEC filed a lawsuit against WorldCom, charging it with fraud.

[4] Information in this paragraph is drawn from: "What Directors Think. Annual Board of Directors Survey," *Corporate Board Member* and Pricewaterhouse Coopers', 2004; "Directors Ride Through Rough Times," *Corporate Board Member*, Nov./Dec., 2002; "Canadian Board Index 2003," SpencerStuart and Rotman School of Management, 2004; "Non-executive directors. Where's all the fun gone?" *The Economist*, March 18, 2004.

[5] "Leadership, Accountability and Partnership: Critical Trends and Issues in Corporate Social Responsibility," Cambridge: John F. Kennedy School of Government (Harvard University), 2004.

Already feeling strained by calls for greater vigilance in their stewardship of shareholder interests, board members are not likely to greet with enthusiasm demands that they also admit stakeholders into their portfolio of responsibilities. But as the consensus at the Harvard gathering suggested, such demands are likely to intensify. Directors will therefore need to deepen their understanding of the links between stakeholder expectations on the one hand, and corporate governance on the other. They will need to understand what the growing significance of CSR means for the performance of their job.

3. CSR – Old Song, New Beat

Although CSR is often spoken of as if it were a relatively new concept, it is in fact an idea with a long pedigree. Fifty-four years ago, in 1950, the chief executive officer of the American retailer Sears said that the "four parties to any business in the order of their importance" were "customers, employees, community and stockholders".[6] A year earlier, a prominent official giving testimony at a US Senate confirmation hearing observed similarly:

> While I would not depart from the basic principle that great institutions such as our corporations must recognize their social responsibility as a moderating influence on the quest for private profits, I think it is pretty generally recognized today that the acceptance of such responsibility is not only a corporate duty, but that in the long run it benefits, through increased prosperity, the corporate owners themselves.[7]

Even then – 55 years ago – the speaker had suggested that a corporation's social responsibility was "generally recognized." Indeed, current discussions about CSR evoke old questions about the place of corporations in society, the manner in which corporations are governed, and the ways in which corporate governance arrangements compel (or don't compel) corporations to respond to claims from society, in addition to claims from shareholders.

While CSR is an old idea, its emergence as a significant factor in relation to corporate decision-making is relatively new. As recently as 1970, Nobel laureate Milton Friedman[8] asserted that "the business of business is business" and that corporate social responsibility was a "fundamentally subversive doctrine" tantamount to "pure and unadulterated socialism."[9] While few would have subscribed fully to Friedman's extreme view, it is safe to assume that it was closer to the mainstream in 1970 than it is today.

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[6] Cited in "A Stakeholder Framework for Analyzing and Evaluating Corporate Social Performance," by Max Clarkson, *Academy of Management Review*, Vol. 20 (1995), No. 1, p. 92.
[7] *The Years of Lyndon Johnson. Master of the Senate*, by Robert A. Caro, New York: Vintage Books, 2003, p. 268.
[8] He won the Nobel Prize for economics in 1976.
[9] "The Social Responsibility of Business is to Increase its Profits," by Milton Friedman, *The New York Times Magazine*, Sept. 13, 1970.

It was not until the early 1990s that CSR began been seen as a significant factor for corporate executives.[10] By the end of that decade, popular opinion about the role of business in society had evolved to a point which suggested a widespread rejection of Friedman's "the business of business is business" dictum. A global survey undertaken in 1999 found that citizens in most countries attached more importance to the role of corporations in "building a better society" than in "making profit." Canadian views on this point were especially strong.[11] More recent research has shown that most Canadians hold business jointly responsible, with government, for addressing social issues ranging from human rights and poverty alleviation to environmental protection and community development.[12]

Why has this old idea – CSR – risen over the past 10 years or so to a prominent place on the corporate agenda? Why are we witnessing what appears to be a transformation in popular views about the role of business in society that is on a par with major shifts in attitude, at other points in history, about large issues such as racial discrimination, the environment, and the role of women?

The answer lies in the convergence of factors such as:

- ***Globalization***: There are now estimated to be over 60,000 multinational corporations in the world[13]. Perceptions about the growing reach and influence of global enterprises has drawn attention to the impact of business on society. This has led to heightened demands for corporations to take responsibility for the social, environmental and economic effects of their actions It has also spawned more aggressive demands for corporations to go beyond limiting harm, and to actively seek to *improve* social, economic and environmental circumstances.

- ***Loss of Trust***: High-profile cases of corporate financial misdeeds (Enron, WorldCom, Hollinger and others) and of social and environmental irresponsibility (e.g. Shell's alleged complicity in political repression in Nigeria; Exxon's oil spill in Prince William Sound in Alaska; Nike's (and other apparel makers') link with "sweatshop" labor in developing countries; questions about Nestlé's practices in marketing baby formula in the developing world) have contributed to a broad-based decline in trust in corporations and corporate leaders. The public's growing reluctance to give corporations the benefit of the doubt[14] has led to intensified scrutiny of corporate impact on society, the economy and the environment, and

[10] For example, see "Corporate social responsibility. Two-faced capitalism," *The Economist*, Jan. 22, 2004; "Corporate Timeline," by Iain Ferguson and Caspar Henderson, *openDemocracy*, March 12, 2003.
[11] "The Millennium Poll on Corporate Social Responsibility," Environics International Ltd., 1999. The study covered 25,000 people in 23 countries.
[12] "Corporate Social Responsibility Monitor," Environics International Ltd., 2002.
[13] *World Investment Report 2004. The Shift Towards Services*, Geneva: UNCTAD, 2004.
[14] Canadians rank CEOs along with politicians among the least trusted professions. More than 8 out of 10 Canadians believe that corporate executives are "likely to lie" when making statements to the news media. See "So, Whom Do We Trust?", Toronto: Ipsos-Reid (2003); "So, Who Do Canadians Think Lie Like a Rug?", Toronto: Ipsos-Reid (2002).

greater readiness to assume (rightly or wrongly) nefarious corporate intent.

- ***Civil Society Activism***. The growing activity and sophistication of "civil society" organizations, many of which are oriented to social and environmental causes, has generated pressure on corporations to take CSR seriously[15]. Well-known international "non-governmental organizations" (NGOs) such as Oxfam, Amnesty International, Greenpeace, the Rainforest Action Network, and the Fair Labor Association have influenced corporate decision-making in areas such as access to essential medicines, labor standards, environmental protection and human rights. The advent of the internet has increased the capacity of these organizations – as well as a plethora of national and local civic associations – to monitor corporate behavior and mobilize public opinion.[16]

- ***Institutional Investor Interest in CSR***. The growth in "socially responsible investing" has created institutional demand for equity in corporations that demonstrate a commitment to CSR. At the end of 2003, $(US) 2.2 trillion in assets were in professionally managed portfolios in the US that used socially responsible investing strategies. (The comparable total at the end of 1997 was $1.2 trillion.) This represented 11 percent of all assets under professional management in the US. Recent growth in assets involved in socially responsible investing has outpaced growth in all professionally managed investment assets in the US[17]. (On the other hand, the mainstream financial community has been slow to incorporate non-financial factors into its analyses of corporate value[18]. As noted below, there are signs that this is changing.)

What these trends suggest is that there is both a *growing perception* that corporations must be more accountable to society for their actions, and a *growing willingness and capacity* within society to impose accountability on corporations. This has profound implications for corporate governance.

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[15] The International Chamber of Commerce, a global advocacy group for the private sector, observed in 2000 that "non-governmental organizations have gained an enormous influence" over corporate decision-making. See "Business, Government and Civil Society – Working Together for a Better World," by Louise Barrington, *Asian Review of Public Administration*, Vol. XII, No. 1 (January-June 2000).

[16] "Civil society" is sometimes described as the part of society that exists between the state and the market. A more formal definition is "the voluntary association of citizens, promoting their values and interests in the public domain." See "Civil Society and Public Governance. Getting a Fix on Legitimacy," by John Saxby and Mark Schacter, Ottawa: The Conference Board of Canada, 2003. It is estimated that there are approximately 48,000 international NGOs, and that total membership in international NGOs grew by about 70 percent between 1990 and 2000. See *Global Civil Society 2003.* Oxford: Oxford University Press, 2003.

[17] Socially responsible investing is a process of identifying and investing in companies that meet certain CSR standards. Data are from "2003 Report on Socially Responsible Investing Trends in the United States," Washington, DC: Social Investment Forum, 2003. See also www.socialinvest.org

[18] "Big investors want SRI research: European institutions to allocate part of brokers' fees to 'non-traditional' information," *Financial Times* (UK), Oct. 18, 2004

4. Governance by Any Other Name

The rise in importance of CSR since the early 1990s paralleled growing concern during the same period[19] about the quality of corporate governance, including unease about the capacity and willingness of directors to act as a check on the exercise of power by corporate executives. But, strikingly, the two issues have been treated separately, each with its own intellectual framework, and its own distinct cadre of experts, practitioners and advocates. Only very recently have there been notable signs of interest in forging a better understanding of the relationship between the two.[20]

The tendency to view CSR and corporate governance as distinct subjects risks distracting corporate directors from recognizing a fundamental shift in the "rules of the game" that is affecting the exercise of corporate power and the accountability of corporate decision-makers. CSR is, at its root, a discussion about constraints and influences on the exercise of corporate power. It is therefore best understood in the context of a larger discussion about corporate governance. Directors will be better prepared to play their oversight role with respect to corporate executives if they see CSR in this light.

To understand why this is so, consider the case of Home Depot Inc., the giant US-based home-improvement chain and the world's largest retailer of lumber. In late 1998 it was targeted by the Rainforest Action Network (RAN), an environmental NGO, for doing business with lumber suppliers whose logging practices were said to be contributing to the destruction of old-growth forests. In a well-publicized campaign, RAN labeled Home Depot "the biggest old-growth retailer in the world", and organized protests at Home Depot stores, at the corporation's headquarters and at shareholder meetings. Ten months after RAN launched its campaign, Home Depot, concerned about the risk of a consumer backlash, announced that it would phase out the sale of lumber originating in endangered forests. The company created a new executive position – "environmental global project manager" – and gave that person the authority to terminate logging contracts with suppliers whose practices harmed endangered forests or otherwise hurt the environment. In short order, Home Depot cut off logging contracts in Indonesia and Gabon. Later, it brokered a deal in Chile (where it is a major buyer of lumber) between local environmentalists and two large timber producers that would preserve native forests.[21]

Today, Home Depot pledges not to purchase uncertified wood products sourced from 10 vulnerable forest regions identified by the World Wildlife Fund , and not to accept wood products made from 40 tree species listed as endangered by the World Conservation

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[19] The publication in 1994 by the Ontario Securities Commission of *Where Were the Directors? Guidelines for Improved Corporate Governance in Canada* (the "Dey Report") was a major turning point for governance reform in Canada. In the UK, the watershed "Cadbury Code" on corporate governance was published in 1992.

[20] For example, see "Leadership, Accountability and Partnership," *supra.*

[21] "New Leaf: Once Targeted by Protesters, Home Depot Plays Green Role," *The Wall Street Journal*, Aug. 6, 2004.

Monitoring Centre.[22] In order to fulfill these commitments, Home Depot has developed systems that enable it to track the origin of every wood product that it sells.

A story such as this one is normally presented under the heading of CSR. A closer analysis suggests that it may be more instructive to see it as a case study in corporate governance. After all, when RAN began to engage with Home Depot, what was it really seeking? The immediate issue, to be sure, was minimizing environmental harm caused by Home Depot's suppliers. But in pursuing the goal of getting Home Depot to reform its sourcing of lumber, RAN was forcing a deeper dialogue about:

- how to constrain the power of the corporation;
- the limits within which Home Deport should pursue shareholder interests (denuding tropical rainforests might serve shareholder interests, at least over the short term);
- how decisions ought to be made about striking a balance between shareholder interests and broader social interests;
- the parties whose views and preferences ought to be taken into account, and who ought to have a say, in corporate decision-making.

Whatever the particular subject matter, a similar pattern is visible in other well known cases in which stakeholder groups have engaged with corporations on questions of environmental and social impact – whether it be The Gap Inc. and Nike Inc. regarding labor practices in developing countries, or Royal Dutch/Shell and its impact on politics and communities in Nigeria, or Talisman Energy Inc. and its involvement in Sudan. In every instance, the underlying story has been about affecting the exercise of corporate power and shaping the direction of corporate decision-making. In other words, it has been a story about governance, even if the individual stories have often been described and analyzed using the vocabulary of CSR.

Corporate governance is the set of formal and informal rules and practices that determine how corporate power is exercised, how corporate decisions are taken, and how corporate decision-makers are held accountable for serving the corporate interest. This is precisely the arena within which RAN was engaging Home Depot. Through pressure campaigns, dialogue with the company and dissemination of information to customers and shareholders about the destruction of rainforests, RAN aimed to gain influence over corporate decision-making, and compel the company to hold itself accountable for the environmental consequences of its suppliers' logging practices. It was attempting to constrain the exercise of corporate power in order to bring it more closely into alignment with the interests of environmental stakeholders. To the extent that RAN was successful in achieving any of these objectives, it became part of the corporate governance system related to Home Depot.

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[22] The details of Home Depot's "Wood Purchasing Policy" are available at http://www.homedepot.com/HDUS/EN_US/corporate/corp_respon/wood_purchasing_policy.shtml

5. Whose Interests Are Served?

If corporate governance is about aligning the behavior of corporate executives with the broader corporate interest, then this begs a larger question about the "corporate interest". Where does it reside, and what does it look like? The answer to this question sheds further light on the merging of CSR into the larger issue of corporate governance.

According to the traditional view of the corporation, management serves the corporate interest by serving the interest of shareholders. Special precautions have to be taken to ensure that this happens. Shareholders, after all, have neither the time, the expertise nor the inclination to be directly involved in overseeing the corporation. Because executives have more information about day-to-day operations that shareholders do, opportunities may arise for executives to exploit the corporation for their own interests, at the expense of the broad mass of shareholders. (Recent experience demonstrates how often, and to what extremes, this scenario plays itself out.)

The corporate governance system is supposed to manage the risk of executive misbehavior. The board of directors is a key element of it – together with, among other things, the legal system, securities commissions, stock exchanges, institutional investors, the financial press. The board acts as a proxy for shareholders, serving as a countervailing force against the unchecked exercise of power by the CEO.

Suppose now that we move from this simple and traditional model of the corporation to a more complicated model (Figure 1, p. 17) that is better suited to the reality of situations like Home Depot (and Nike, The Gap, Talisman, Shell, etc.). This model depicts a world where the "corporate interest" that is supposed to be served by executives, and protected by the board of directors, is defined not only by the expectations of shareholders, but also by the expectations of a wider range of stakeholders. This fuller view of corporate governance has been well described by Sir Adrian Cadbury, a pioneer of recent governance reform, who observed that

> Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals ... The aim is to align as nearly as possible the interests of individuals, corporations, and society.[23]

In the well known CSR cases cited above, stakeholders exerted claims on the corporation – not the financial claims that a shareholder makes, but *social* claims. They demanded that the company generate a positive social return (or minimize a negative social return). And, to varying degrees, the corporations treated these claims as legitimate, altered their decision-making, and allowed stakeholder preferences to act as a constraint on the exercise of corporate power. The corporations treated stakeholder representatives *as if* they were shareholders, even though there was no formal requirement that they do so. They responded to stakeholders *as if* they had a right to a say in how the company was

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[23] "Corporate Governance: A Framework for Implementation. Overview" ("Foreword" by Sir Adrian Cadbury), Washington: The World Bank, 1999.

operated. Whether deliberately or not, they gave stakeholders a role in the governance system that controls the exercise of corporate power.

6. Governance, Stakeholders, and Networks

The idea that corporations negotiate social (as well as financial) claims in a governance system that embraces stakeholders (as well as shareholders) leads to the view that corporate accountability for social (as well as financial) outcomes is a governance issue that belongs squarely on the board's agenda. From this perspective, the management of stakeholder relationships is a strategic issue of the highest order, because it speaks to the long-term health, and survival, of the corporation.

The model for this view of corporate governance – a model which encompasses the conventional discussion about CSR – portrays the corporation as operating in a network of relationships among stakeholders.[24] If an important member of the network withdraws its support from the corporation, then the health (and, over the long term, the survival) of the corporation is threatened[25].

Applying this model to the Home Deport case, we see that the corporation's network of key stakeholders was disrupted by the forcible entry of RAN (Figure 2, p. 18). Once inside the network, RAN moved quickly to establish direct relationships with Home Depot and with its customers. This, in turn, affected other key relationships. Most significantly, Home Depot was compelled to make a quick decision about the kind of relationship it wanted to build with RAN. It decided to attempt to build a positive one. Doing so required it to substantially alter – even terminate – its relationships with some of its suppliers. All of this was done in recognition of RAN's capacity to affect Home Depot's relationship with a key stakeholder: its customers. (Home Depot was presumably also concerned about the impact of RAN's campaign on its relationship with investors, whose confidence in Home Depot's ability to manage its customer base would have to be maintained. It is also reasonable to assume that Home Depot would have been concerned about the impact of the RAN campaign on its relationship with its employees, whose attitudes about the company might have been negatively affected, *as well as* RAN's impact on Home Depot's suppliers' relationships with regulators in their own home countries.)

The "balance between economic and social goals and between individual and communal goals" that Cadbury described as being at the heart of corporate governance (above, p. 8) is continuously negotiated and renegotiated, formally and informally, within these networks of relationships. Achieving the right balance, and adjusting it over time in light of changing circumstances (as Home Depot had to do) is critical to the long-term health of the corporation and is therefore a strategic corporate issue. If board members are going to be well equipped to fulfill their fundamental responsibility to "ensure the

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[24] For example, see *Stakeholder Relationships, Social Capital and Business Value Creation*, by Ann C. Svendsen, et. al., Toronto: Canadian Institute of Chartered Accountants, 2003.
[25] An early expression of this idea is seen in "A stakeholder framework for analyzing and evaluating corporate social performance," *supra*.

strategic guidance of the company"[26] they must understand the composition and the dynamics of the corporation's stakeholder network. They must recognize that the corporation needs to be governed in a way that supports the care and feeding of the network.

7. What is on the Horizon?

The foregoing analysis suggests that we are in the midst of a transformation in the "rules of the game" related to corporate governance. Often described and explained in terms of "corporate social responsibility," this transformation has two key features: the entry of new players into the governance system that controls the exercise of corporate power, and the intensification of demands on corporations to take responsibility, and be accountable, for the social, environmental and economic impact of their decisions. Going forward, what trends are likely to emerge in these areas that will have an important impact on the job of the corporate director? This section of the paper speculates that four developments will be especially significant over the next several years:

- **growing pressure on corporations to give stakeholders a role in corporate governance;**
- **growing pressure on corporations to disclose more and better information about their management of social, environmental and economic issues;**
- **increasing regulation of elements of corporate activity that are currently regarded as voluntary forms of social responsibility;**
- **growing interest by the mainstream financial community in the link between shareholder value and non-financial corporate performance.**

(a) Growing Pressure to Give Stakeholders a Role in Governance

The growth in the size, strength and sophistication of civil society organizations worldwide (above, p. 5) is likely to continue, leading to intensified demands by civic groups for access to and influence over corporate decision-making. In Canada, at least, many corporate boards of directors appear unready to rise to this challenge. A study of Canadian corporate boards showed that only 4 per cent had a committee that focused on "public policy and social responsibility." Only a quarter of boards had formal processes for overseeing "non-shareholder interests."[27]

With a growing number of stakeholder groups demanding influence over corporate decision-making, corporations will have to become more sophisticated in the manner in which they make choices about whom they will engage with in civil society and whom they won't. Although the day-to-day handling of relationships with stakeholders is a task

[26] *OECD Principles of Corporate Governance*, Paris: OECD, 2004.
[27] *Corporate Board Index 2003*, *supra*.

for management, directors will have to be knowledgeable about and watchful of this governance process. A recent analysis[28] proposed that organizations should base their decisions about engaging with civil society organizations on judgments about those organizations' "legitimacy". Legitimacy, for this purpose, is sub-divided into three factors: (i) values; (ii) representation and accountability; (iii) credibility and competence.

Values. Even if a civil society organization is a strong opponent of certain corporate practices, it may still be possible for the corporation to enter into a fruitful relationship with it if both parties share fundamental values that are relevant to the disputed corporate policy or practice. (In the Home Depot case, both the company and RAN espoused a commitment to the preservation of old-growth forests.) But when there are significant differences in values held by the company and the civil society group, engagement should be avoided.

Representation and Accountability. Civil society organizations that demand influence over corporate decision-making will usually purport to be representing the values and objectives of a larger constituency. This claim should be verified, as should the degree to which the civil society organization holds itself accountable to the constituency that it claims to represent. A recent study found that many major international NGOs have mixed records with respect to representation and accountability.[29]

Credibility and Competence. The legitimacy of an organization is, among other things, a practical matter. Competence, which creates credibility, is about performance, expertise, and "track record." Quite simply, is a given civil society organization that is demanding influence over corporate decision-making good at what it does? Many of the policy-oriented civil society organizations that seek to engage with corporations will be involved in both research and advocacy – a combination that can lead to questions about the quality – primarily the objectivity and rigor – of their research.

(b) Growing Pressure Related to Social, Environmental and Economic Disclosure

Corporations have already begun to respond to demands from stakeholders (including governments and regulators – see below) to provide detailed reporting on social, environmental and economic impacts in addition to the standard, and obligatory, disclosures on corporate financial performance and risk. The routine publication of reports describing corporate impact on society, the community and economy – often referred to as "social reports", "CSR reports" or "triple-bottom-line" reports – was launched by a small number of companies in the early 1990s. Supply of these reports led quickly to heightened demand – both for existing reporters to produce more and better information, and for non-reporters to begin reporting. This pressure is certain to intensify.

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[28] "Civil Society and Public Governance. Getting a Fix on Legitimacy," *supra*.
[29] "Power Without Accountability," by Hetty Kovach, et al., London: One World Trust, 2003. See also "Holding Civic Groups Accountable," *The New York Times*, July 21, 2003.

Corporate social reporting already grown rapidly. The number of companies producing "significant" corporate social reports swelled from virtually nil in 1990 to more than 1,500 today.[30] (On the other hand, tens of thousands of corporations still do not produce social reports.) In Canada, the number of companies producing social reports nearly doubled from 57 in 2000 to 100 in 2002.[31]

Because corporate social reporting is in its infancy, a number of significant matters remain to be resolved. Key issues are standardization and assurance.

Standarization. There is a plethora of norms and standards related to what ought to be contained in a social report; there are no "Generally Accepted Accounting Principles" for social reporting.[32] An emerging *de facto* standard is the set of social reporting guidelines first published in 2000 by the Global Reporting Initiative (GRI), a multi-stakeholder initiative founded in 1997 involving NGOs, the investment community, assurance providers and regulators. At the moment there are approximately 600 companies that are known to use, or to make reference to, the GRI guidelines in their social reports.[33]

Assurance. Traditional financial reports are given credibility by being independently audited, according to prescribed standards. Young as social reporting is, assurance of social reporting is younger still. The first social reporting assurance standard was published in 2003 by a UK-based think tank, AccountAbility[34]. Some companies that produce externally-audited social reports are now using it or referring to it. About 40 percent of all hardcopy social reports produced in 2003 included some form of external assurance.[35]

(c) Increasing Regulatory Compulsion in Areas Once Voluntary

In 1802 the British Parliament passed the *Factory Act*, which mandated that the working hours of boy and girl apprentices in cotton and woolen mills were "not to exceed twelve a day, nor commence before six in the morning, nor conclude after nine at night", and that boys and girls were "to be provided with separate sleeping apartments, and not more than two to sleep in one bed." One might assume that a mill owner who chose to treat his young employees to a standard exceeding the *Act* was, by the norms of the day, practicing "social responsibility."

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[30] *Towards Transparency*, London: Certified Accountants Educational Trust, 2004.
[31] "Building Confidence. Corporate Sustainability Reporting in Canada," Ottawa: Stratos Inc., 2003.
[32] It is important to put this, and other unresolved issues related to social reporting, in historical perspective. Comparisons with the more settled nature of financial reporting should bear in mind that social reporting is little more than 10 years old, while double-entry financial bookkeeping has been in use for at least 600 years. Even now, financial accounting standards are still evolving, and are occasionally the subject of controversy.
[33] *Towards Transparency*, *supra*. For information on the GRI standards, see www.globalreporting.org.
[34] See www.accountability.org.uk/aa1000/default.asp?pageid=52. Here again (see footnote 32) it is important to view these developments in their historical perspective. In the US, disclosure by publicly-traded corporations of audited financial information was done on a voluntary basis until 1933.
[35] *Towards Transparency*.

CSR is commonly thought of as being at the discretion of the company; it is what a company does in the social, environmental and economic spheres that exceeds legal requirements.[36] But as the example of the *Factory Act* reminds us, the law is not static. Over time, as society's views evolve regarding what constitutes a minimum acceptable standard of corporate behavior, items migrate from the realm of corporate discretion to the realm of legal and regulatory compulsion[37]. Child labor is but one obvious example; others include the minimum wage, statutory holidays, workplace safety, employment equity, racial discrimination, environmental protection, product safety, food labeling, advertising of alcohol and cigarettes, etc.

It's an open question today as to whether or not the rate at which various elements of corporate practice are moving from discretion to compulsion is accelerating. But given the social and economic undercurrents noted above (p. 4) – i.e. the backlash against globalization, the loss of trust in institutions, the growing influence of civil-society activism, and the awakening of the financial community to the significance of non-financial corporate performance – it is not unreasonable to assume that pressure to push things across the boundary from discretion to compulsion will intensify. Recent examples from Canada and around the world provide a sense of some areas in which this process continues to unfold:

- In early 2004, the Canadian government enacted an amendment to the *Criminal Code*[38] which makes it easier to lay criminal charges against corporations in cases of workplace health and safety violations within Canada. The government is expected to face pressure to extend the applicability of this law to the overseas activities of Canadian corporations.[39] In late 2004, the UK government proposed similar legislation,[40] and a prominent UK-based international NGO advocated legislation assigning corporate directors legal liability for harm caused in foreign countries by UK corporations.[41]

- In 2004 the Canadian government altered the intellectual property rights of brand-name pharmaceutical manufacturers in order to facilitate the export of essential medicines to developing countries. An amendment to the *Patent Act* allowed generic drug manufacturers to obtain licenses to produce cheaper versions of patented medicines for the purpose of supplying these drugs – for diseases such as HIV/AIDS, malaria and tuberculosis – to developing countries.

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[36] The Canadian government's guidance to industry on CSR observes that "CSR is often understood as involving the private sector commitments and activities that extend beyond this foundation of compliance with laws." http://strategis.ic.gc.ca/epic/internet/incsr-rse.nsf/en/h_rs00094e.html
[37] This idea is developed in "The Virtue Matrix," by Roger Martin, *Rotman Management* (Spring/Summer 2003).
[38] Bill C-45, commonly referred to as the *Westray Bill*.
[39] Edward Broadbent, a member of the opposition New Democratic Party, has indicated that he intends to introduce into Parliament an amendment to this effect.
[40] "Corporate killing bill unveiled," *The Guardian*, Nov. 23, 2004.
[41] "Behind the mask. The real face of corporate social responsibility," London: Christian Aid, 2004.

- In 2004, the state of Maine passed the first legislation in the US that would require manufacturers to share responsibility with consumers and governments for the recycling of televisions and computer monitors.

- In 2003, the Danish government, in response to concerns about damage to health caused by trans fatty acids, which are commonly found in popular processed foods, enacted regulations limiting the amount of trans fat that may be used by food manufacturers.

One area that will be of particular interest to directors, because of their duties related to oversight of corporate disclosure, is the trend toward increased regulation of corporate disclosure of non-financial information. As noted (p. 11), corporations have been responding voluntarily to pressure to report on their social, environmental and economic impact. Recently, governments around the world have become more directly involved For example:

- The Canadian Securities Administrators introduced in 2004 rules related to the continuous disclosure obligations of listed companies, which require them, among other things, to describe their "fundamental" social and environmental policies, and the steps they are taking to implement them.

- The UK government plans to require publicly traded companies to produce an Operating and Financial Review that will disclose information relevant to corporate operations in areas such as the environment, social and community issues, employees and customers.

- The *New Economic Regulations* enacted in France in 2003 require listed companies to report publicly against certain social and environmental indicators.

- Listing requirements enacted in 2003 by the Johannesburg Stock Exchange require companies to use the GRI Guidelines (see p. 12) for the disclosure of social and environmental performance.

It is highly likely that this trend will accelerate, and that regulators will, over the medium-term, become increasingly demanding of corporations with respect to non-financial reporting.[42]

(d) Increasing Interest by the Financial Community in Non-financial Performance

Even with the rapid rise of "socially responsible investing" (see p. 5) the mainstream financial community has been slow to acknowledge linkages between a corporation's non-financial performance and its capacity to generate a financial return to shareholders.

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[42] "Risk & Opportunity. Best Practice in Non-Financial Reporting," London: SustainAbility, 2004.

There are signs that the financial community may be ready to begin taking non-financial performance, and the board's oversight of it, more seriously. One noteworthy indication of this was the recent decision by Standard & Poors (S&P) to partner with the UK-based think tank SustainAbility, and the United Nations Environment Programme, in the production of the 2004 edition of a highly-regarded biennial review of corporate non-financial reporting[43]. S&P attributed its participation in the report to the "growing importance of non-financial disclosure in the overall assessment of a company's risk profile."[44] As a global provider of corporate analysis and risk assessment to financial markets, S&P's influence on conventional wisdom in the financial community is considerable.

An S&P executive described his expectations, when evaluating the quality of corporate risk management, of directors' involvement in non-financial issues:

> ... we look for evidence that the company has identified material social and environmental risks and has introduced processes and controls to manage and govern the company with regard to these risks. *These matters should have explicit board oversight.*[45]

The S&P executive noted that it would be "alarming", from the perspective of corporate risk assessment, if it was found that board oversight of social and environmental risks was non-existent or minimal.[46]

In another recent development, a group of leading European institutional investors called on the investment and brokerage communities to produce better research on non-financial corporate issues such as environmental management, human resource management, labor relations and corporate governance. The consortium offered to contribute to the funding of such research. A representative of the group predicted that "If we look five years ahead we think these issues will eventually be part of mainstream financial research."[47] If this prediction is correct, then the clear implication is that the capacity of boards to understand non-financial risks, and to oversee management's handling of them, will come under intense scrutiny.

8. Conclusion

Where once directors were asked to look out for shareholder interests, they are now beginning to be asked to be the stewards of stakeholder interests as well. This discussion about corporate accountability to stakeholders, while often couched in the vocabulary of CSR, is really a discussion about corporate governance, which is precisely why it demands a central place on the board's agenda.

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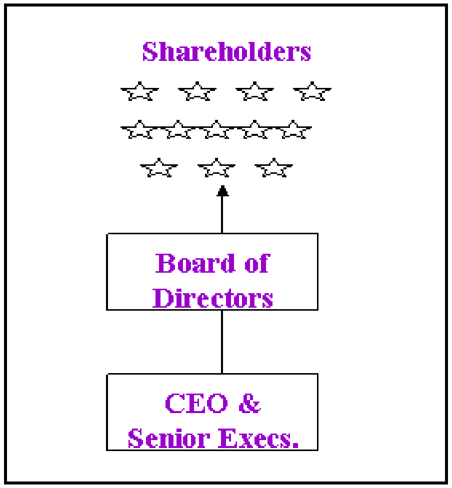
[43] *Idem*.
[44] *Ibid*., p. 2.
[45] *Ibid*., p. 13. Emphasis added.
[46] *Idem*.
[47] "Big investors want SRI research: European institutions to allocate part of brokers' fees to 'non-traditional' information," *supra*.

At its core, CSR is about widening the range of players deemed to have a legitimate role in shaping corporate decision making and controlling the exercise of corporate power. The appropriate response by corporate directors to CSR is therefore to develop a fuller appreciation of the new governance environment within which publicly traded corporations are operating. A key feature of this environment is increasing pressure on corporations to achieve, as Lord Cadbury put it, a better alignment between "the interests of individuals, corporations, and society." Board members will play a central role in steering corporate executives toward achievement of this alignment. Doing so will involve admitting stakeholders into the corporate governance system, and holding the corporation answerable to the social claims and demands for non-financial information made by stakeholders, just as it is answerable to the financial claims and demands for information made by shareholders.

The challenge that this implies is a considerable one. In order to help the corporation navigate the best possible path among the competing claims of shareholders and stakeholders, directors will have to deepen their appreciation of the networks of relationships – social as well as financial – that sustain the corporation. They will also have to build their capacity to oversee the corporation's response to intensifying demands from governments and the financial community for greater rigor in the management of, and disclosure of information about, social impact.

Figure 1



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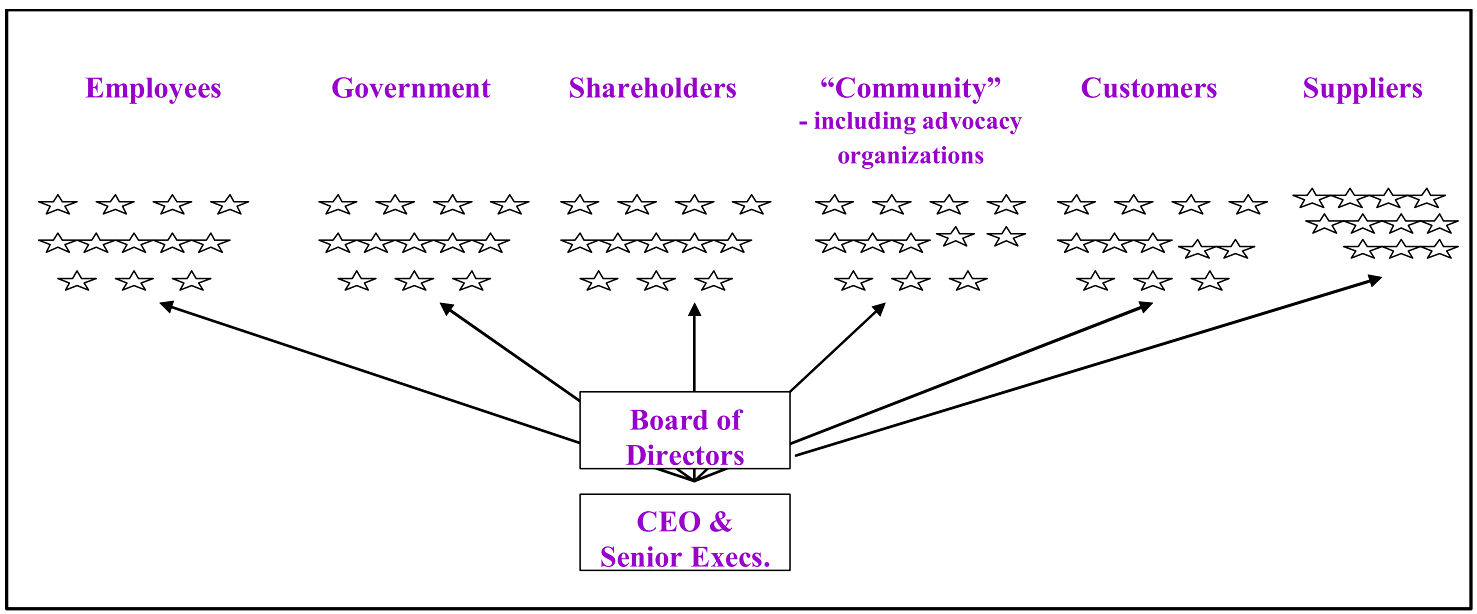
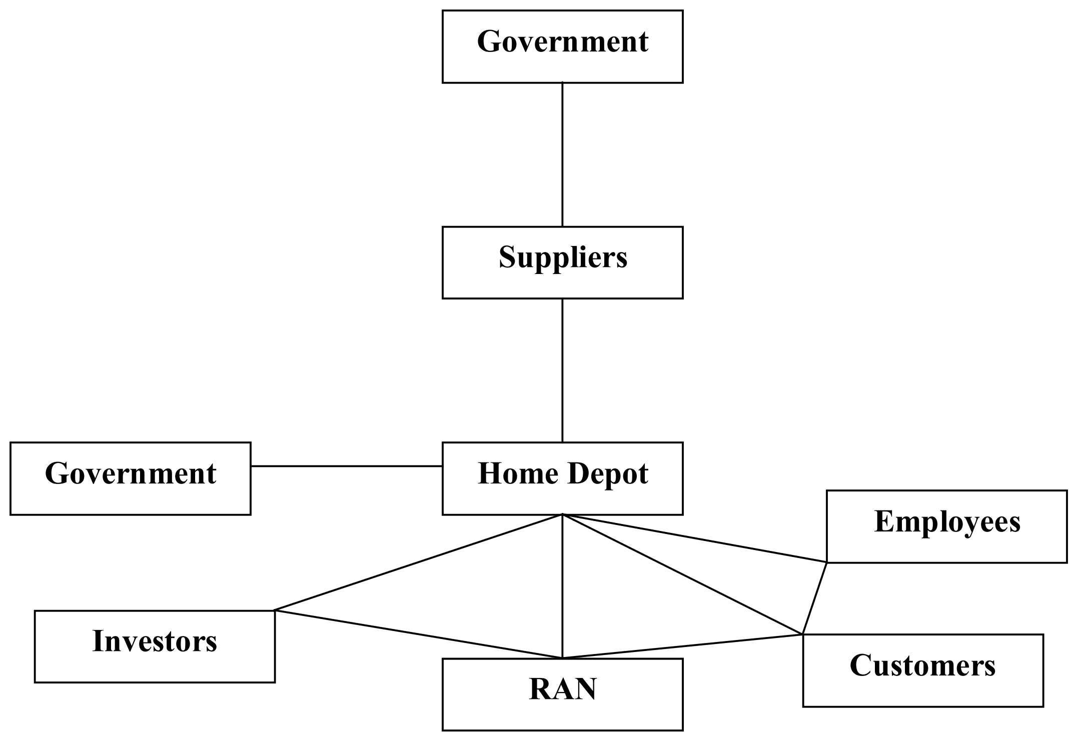


Figure 2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